# Explanatory Notes to the Legislative Proposals and Draft Regulations Relating to Income Tax

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Minister of Finance

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Canada

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# Explanatory Notes

# PREFACE

These explanatory notes describe proposed technical amendments to the *Income Tax Act* and related Acts. Those amendments are divided into two parts, the first part relating to general income tax amendments and the second part relating to amendments to the foreign affiliates regime.

Many of the provisions released in the December 2002 release of legislative proposals have been revised in response to consultations undertaken since that time. As a result, certain clauses of the explanatory notes previously released with the proposed amendments have also been revised or added as necessary.

These explanatory notes, like the amendments, are divided into two parts: notes in respect of general income tax amendments followed by notes in respect of the foreign affiliates regime. Under the first part, explanatory notes are provided only in respect of clauses which have been changed or which are new. Within each such clause, only those explanatory notes which have been changed or which are new are produced.

The explanatory notes contained under the second part replace the explanatory notes released in December 2002 concerning sections 17, 93, and 95 and the definition "qualifying member" in subsection 248(1) of the Act. Note also that the explanatory notes previously released concerning Part LIX of the *Income Tax Regulations* are replaced by the explanatory notes to Appendix C. Unless otherwise noted, any of the previously released explanatory notes concerning those provisions of the Act and Part LIX that are not reproduced have been deleted.

Note also that the amendments to the following provisions, originally proposed in the December 2002 draft legislative proposals were included in Bill C-48, which received Royal Assent in November 2003, and, accordingly, the explanatory notes for those provisions in Bill C-48 apply:

> Paragraph 12(1)(*o*); paragraph 18(1)(*m*); subparagraph 66(12.66)(*b*)(ii); paragraph (*g*) of the definition "Canadian resource property" in subsection 66(15); subsection 66(17); paragraph (*e*) of the definition "Canadian development expense" in subsection 66.2(5); the description of "F" in the definition "cumulative Canadian development expense" in subsection 66.2(5); paragraph (*a*) of the definition "Canadian oil and gas property expense" in subsection 66.4(5); the description of "F" in the definition "cumulative Canadian oil and gas property expense" in subsection 66.4(5); subsection 69(6); and subsection 104(29).

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# PART I

# GENERAL

## Clause 2

## Employment Income

ITA
6

Section 6 of the Act deals with employment income. This section provides for the inclusion in an employee's income of most employment-related benefits other than those specifically excluded.

## Amounts Receivable for Covenant

ITA
6(3.1)

New subsection 6(3.1) of the Act provides that an employee is - if certain circumstances exist - required to include in the employee's income from employment for a taxation year an amount that is receivable at the end of a taxation year in respect of a covenant as to what the employee is, or is not, to do. Subsection 6(3.1) is added consequential to new section 56.4 of the Act which concerns the tax treatment of amounts received or receivable in respect of a restrictive covenant (additional commentary is provided in the explanatory notes accompanying new section 56.4)). In contrast, amounts related to covenants made in the context of an office or employment are generally included in income on a "received" basis.

New subsection 6(3.1) applies to a receivable of an employee in respect of a covenant if

- the amount is not receivable under a salary deferral arrangement to which paragraph 6(1)(*a*) applies because of subsection 6(11) (in such cases, the amount is currently taxable as employment income even though it is receivable),
- the employee agreed to the covenant more than 36 months before the end of the taxation year, and
- the amount would be included in the taxpayer's income, as income from an office or employment, if it were received by the taxpayer in the year.

If applicable, subsection 6(3.1) provides that the amount receivable is deemed to be received by the taxpayer at the end of the taxation year for services rendered as an officer or during the period of employment, and that the amount is deemed not to be received at any other time (thereby precluding an inclusion because of the receipt).

In cases where subsection 6(3.1) deems an amount that is receivable to be received, new paragraph 60(*f*) provides a deduction in a subsequent year if the amount becomes a bad debt.

Subsection 6(3.1) applies to amounts receivable in respect of a covenant agreed to after October 7, 2003.

**Clause 5**

**Income Inclusions**

**Inducements, Reimbursements, etc.**

ITA
12(1)(*x*)(v.1)

Paragraph 12(1)(*x*) of the Act provides that certain inducements, reimbursements, contributions, allowances and assistance received by a taxpayer in the course of earning income from a business or property must be included in income "to the extent that" the particular amounts have not otherwise been included in income or reduced the cost of a property or the amount of an outlay or expense. Paragraph 12(1)(*x*) is amended consequential to the restrictive covenant rules in new section 56.4 of the Act (additional commentary is provided in the explanatory notes accompanying new section 56.4).

New subparagraph 12(1)(*x*)(v.1) provides that the income inclusion referred to in paragraph (*x*) does not apply to the extent the amount in respect of a restrictive covenant (as defined by new subsection 56.4(1)) was included under subsection 56.4(2) in computing the income of a person related to the taxpayer. In other words, to the extent that a taxpayer receives an amount for a restrictive covenant that a person related to the taxpayer is required under subsection 56.4(2) to include in computing income, paragraph 12(1)(*x*) will not apply to require the taxpayer to include the amount in computing the taxpayer's income.

New subparagraph 12(1)(*x*)(v.1) applies after October 7, 2003.

## Clause 7

### Eligible Capital Property

### Election re Capital Gain

ITA
14(1.01)

Subsection 14(1.01) of the Act permits a taxpayer to elect, in the taxpayer's return of income for a taxation year, to report a capital gain on the disposition of an eligible capital property in respect of which the taxpayer can identify the cost of the particular property. Where the taxpayer has so elected, the taxpayer is deemed to have disposed of a capital property with an adjusted cost base equal to that cost, for proceeds of disposition equal to the actual proceeds of the eligible capital property. Paragraph 14(1.01)(*a*) removes the property from the cumulative eligible capital pool by coincidentally deeming the proceeds of disposition of the eligible capital property to be equal to its original cost.

Subsection 14(1.01) is amended to clarify that it is the eligible capital expenditure by the taxpayer to acquire the eligible capital property that must be verifiable.

The amended provision will allow a taxpayer to elect in the taxpayer's return of income for the taxation year of the disposition, or with an election under subsection 83(2) of the Act. This allows a taxpayer to consider the resulting capital gain when making a capital dividend election.

The amendments generally apply to dispositions of eligible capital property that occur on or after December 20, 2002.

### Election re Property Acquired with pre-1972 Outlays or Expenditures

ITA
14(1.02)

Amended subsection 14(1.01) of the Act does not allow a taxpayer to elect under that subsection in respect of a property acquired prior to 1972. New subsection 14(1.02) of the Act is added to allow a taxpayer to make a similar election in respect of property that would, if an outlay or expenditure were made after 1971 to acquire the property, be eligible for the election under subsection 14(1.01). For the purposes of calculating the capital gain to the taxpayer under this election, the adjusted cost base of such property is deemed to be nil

and the proceeds of disposition would be determined under subsection 21(1) of the *Income Tax Application Rules*.

New subsection 14(1.02) applies to dispositions of eligible capital property that occur after December 20, 2002.

**Non-application of Subsections (1.01) and (1.02)**

ITA
14(1.03)

New subsection 14(1.03) of the Act is added, concurrently with the amendment of subsection 14(1.01) of the Act and the addition of new subsection 14(1.02) of the Act, to preclude a taxpayer from making an election under those subsections in respect of eligible capital property that is goodwill. Subsection 14(1.03) also precludes an election by a corporation under those subsections for property acquired in circumstances where an election was made under subsection 85(1) or (2) of the Act, if the amount agreed on as the corporation's cost under those subsections was less than the fair market value of the property at the time it was so acquired. However, this rule only applies in circumstances where the corporation is dealing at non-arm's length with the transferor of the property and the eligible capital expenditure of the transferor to acquire the property cannot be determined. The exclusion from electing for property acquired in a rollover prevents the conversion of property with no determinable cost into property with a cost that is determinable for tax purposes.

New subsection 14(1.03) generally applies to dispositions of eligible capital property that occur after Announcement Date + 1.

**Acquisition of Eligible Capital Property**

ITA
14(3)

Subsection 14(3) of the Act provides rules regarding non-arm's length transfers of eligible capital property. The provision prevents the deduction, under paragraph 20(1)(*b*) of the Act, of the portion of the purchaser's cost that is reflected in a capital gains exemption claimed by the vendor under section 110.6 of the Act. Absent any claim by the vendor of a capital gains exemption under subsection 110.6, the eligible capital expenditure to the purchaser generally equals the proceeds of disposition of the vendor. That is, the eligible capital expenditure of the purchaser equals 4/3 of the amount determined in respect of the vendor under the description of E in the formula in the definition "cumulative eligible capital" in subsection 14(5) of the Act.

Paragraph 14(3)(*a*) is amended, for taxation years that end after February 27, 2000, to ensure that, if the eligible capital property is the subject of an election by the vendor under subsection 14(1.01) or (1.02) of the Act, the eligible capital expenditure of the purchaser will, subject to the adjustments in subsection 14(3) for deductions under section 110.6, equal the actual proceeds of disposition to the vendor.

**Definition of Cumulative Eligible Capital**

ITA
14(5)

The definition "cumulative eligible capital" in subsection 14(5) of the Act provides for the calculation of a taxpayer's cumulative eligible capital property pool for the purpose of determining the taxpayer's allowable deduction in respect of eligible capital property (ECP) for the year.

Variable A in the definition "cumulative eligible capital" represents 3/4 of the eligible capital expenditures of a taxpayer as the result of the acquisition of an eligible capital property after the taxpayer's "adjustment time" (generally since 1987). Variable A is amended to ensure that the taxpayer's pool includes only the taxable portion of the gain realized by the non-arm's length transferor on the disposition after December 20, 2002 of eligible capital property.

Variable A is generally reduced by 1/2 of the gain of the transferor in respect of the property under paragraph 14(1)(*b*) or 38(*a*) of the Act. (Where the transferor has claimed a capital gains exemption in respect of the transfer under subsection 110.6 of the Act, subsection 14(3) of the Act reduces the taxpayer's eligible capital expenditure accordingly. The reduction in Variable A will therefore not include 1/2 of the amount of that claim.) Where the transferor has realized such a gain in a taxation year in respect of more than one property, the amount of the gain of the transferor for the purposes of this calculation is that proportion of the gain that the proceeds of disposition of the eligible capital property acquired by the taxpayer is of the total proceeds of disposition of all such property disposed of in the transferor's taxation year.

The reduction to Variable A does not apply where the eligible capital property has previously been disposed of by the taxpayer or was acquired on or before December 20, 2002.

*Example 1*

*Mr. X purchased a farm production quota several years ago for $300,000 and claimed no cumulative eligible capital amounts, such that his cumulative eligible capital at the end of his previous taxation year was $225,000. This year he sold the production quota to his sister, Mrs. Y, for its fair market value of $1,200,000. Mr. X reported income of $450,000 under paragraph 14(1)(b) of the Act, and did not claim a capital gains exemption under section 110.6 of the Act. (Alternatively, Mr. X could have made an election under subsection 14(1.01) of the Act to report a taxable capital gain under paragraph 38(a) of the Act.)*

*Because Mrs. Y purchased the production quota in a non-arm's length transaction, the amount included in Variable A of her cumulative eligible capital balance at the end of the year of acquisition would be $675,000 (i.e. 3/4 of $1,200,000, less 1/2 of the taxable gain of Mr. X of $450,000). This result may also be illustrated as the total of the taxable gain of Mr. X of $450,000 and 3/4 of his eligible capital expenditure of $300,000.*

*Example 2*

*Assume the same facts as Example 1, except that Mr. X claimed a capital gains exemption of $250,000 in respect of his $450,000 taxable gain under paragraph 14(1)(b) of the Act.*

*Mrs. Y's eligible capital expenditure under subsection 14(3) of the Act is deemed to be $700,000, calculated as 4/3 of the excess of*

- *3/4 of the actual proceeds of disposition of $1,200,000 (i.e. $900,000)*

*over*

- *3/2 of the $250,000 capital gains exemption claimed by Mr. X (i.e. $375,000)*

*The amount included in Variable A of Mrs. Y's cumulative eligible capital balance is calculated as follows:*

| | | |
|---|---|---|
| • *3/4 of her deemed eligible capital expenditure of $700,000* | | *$525,000* |
| *less 1/2 of the amount by which the taxable gain of Mr. X exceeds* | *$450,000* | |
| • *the capital gains exemption claimed by Mr. X* | *250,000* | |
| | *200,000* | |
| | *x 1/2* | |
| | | *100,000* |
| *Amount included in Variable A* | | *$425,000* |

The calculation of "cumulative eligible capital" is designed so that the pool cannot be negative immediately after the end of the year. In this regard, variable F in the calculation generally reduces the pool by the total amount of ECP deductions claimed in prior years (generally, variable P), net of amounts included in income in prior years (variable R) under subsection 14(1) of the Act as recapture of ECP deductions or as deemed capital gains.

Variable R in the definition "cumulative eligible capital" is amended to ensure that amounts included in the income of a corporation under former paragraph 14(1)(*b*) of the Act (as it applied to taxation years that ended before February 28, 2000) continue to be included in the calculation of variable F.

The amendments apply to taxation years that end after February 27, 2000.

**Exchange of Property**

ITA
14(6)

Where a taxpayer has disposed of an eligible capital property in a taxation year and has acquired a replacement eligible capital property before the end of the subsequent taxation year, subsection 14(6) of the Act allows the taxpayer to elect to defer the inclusion of an amount in income under subsection 14(1) of the Act that would normally result from a negative balance in the taxpayer's cumulative eligible capital account at the end of the year of disposition.

Subsection 14(6) is amended to accommodate taxation years that are shorter than 12 months, by providing that the period for acquiring a

replacement property ends at the later of the end of the subsequent taxation year and the time that is 12 months after the end of the taxation year in which the property was disposed of. This amendment applies in respect of dispositions of eligible capital property that occur in taxation years that end on or after the day that is 12 months before December 20, 2002.

**Clause 10**

**Prohibited Deductions**

**Securities Lending Arrangement Compensation Payments**

ITA
18(1)(*w*)

Section 260 of the Act provides special rules relating to securities lending arrangements. Former subsection 260(6) prohibited a borrower, other than in certain circumstances, from deducting in computing its income an amount paid as a compensation payment pursuant to a securities lending arrangement.

As part of the restructuring of section 260, particularly subsection 260(6), new paragraph 18(1)(*w*) is enacted to prohibit a borrower from deducting a compensation payment, except where expressly permitted by the Act. This new paragraph, therefore, continues the function of the former subsection 260(6).

This amendment applies after 2001.

**Clause 12**

**Deductions**

**Reserve Not Available**

ITA
20(8)

Paragraph 20(1)(*n*) of the Act allows a taxpayer to claim a reserve in respect of the taxpayer's profit from the sale of certain property, where all or part of the proceeds of the sale are not due until at least two years after the time of sale. However, subsection 20(8) of the Act provides that this reserve is limited to taxation years that end less than 36 months after the time of the sale. For example, where the taxation year is 12 months, the reserve is available in the taxation

year in which the sale occurred and the two subsequent taxation years.

New paragraphs 20(8)(*c*) and (*d*) generally apply, in respect of dispositions of property that occur after December 20, 2002, to provide that the reserve under paragraph 20(1)(*n*) is not available to a taxpayer where the purchaser of the property is a corporation controlled by the taxpayer or is a partnership of which the taxpayer is a majority interest partner.

**Clause 18**

**Exchanges of Property**

**Where Subparagraph 44(1)(*e*)(iii) Does Not Apply**

ITA
44(7)

Subsection 44(7) of the Act restricts a taxpayer from claiming a capital gains reserve under subparagraph 44(1)(*e*)(iii) where the former property of the taxpayer was disposed of to a non-resident or a corporation that, immediately after the disposition, controlled the taxpayer or was controlled by the taxpayer or by a person or group of persons who controlled the taxpayer. Subsection 44(7) is amended, generally in respect of dispositions of property that occur after December 20, 2002, to provide that the capital gains reserve is also not allowed to a taxpayer where the purchaser of the property is a partnership of which the taxpayer is a majority interest partner.

**Clause 19**

**Capital Gains Deferral - Eligible Small Business Investments**

**Special Rule - Eligible Small Business Corporation Share Exchanges**

ITA
44.1(6)

Subsection 44.1(6) of the Act provides rules that apply where an individual exchanges an eligible small business corporation share for new eligible small business corporation share. Subsection 44.1(6) is amended to substitute the reference to subsection 85.1(3) with a reference to subsection 85.1(1) and to add a reference to sections 51

and 86. These changes apply to dispositions of shares made after February 27, 2000.

**Special Rule - Active Business Corporation Share Exchanges**

ITA
44.1(7)

Subsection 44.1(7) of the Act provides rules that apply where an individual, in the course of a qualifying disposition, disposes of common shares of an active business corporation for consideration consisting only of new common shares of another active business corporation issued to the individual. Subsection 44.1(7) is amended to substitute the reference to subsection 85.1(3) with a reference to subsection 85.1(1) and to add a reference to sections 51 and 86.

These changes apply to dispositions of shares made after February 27, 2000.

**Anti-Avoidance Rule**

ITA
44.1(12)

Subsection 44.1(12) of the Act is an anti-avoidance rule. It applies where an individual or persons related to the individual dispose of shares of a particular corporation (which would normally result in the use of the corporate reorganization rules or a return of paid-up capital of shares of the corporation) and acquire new shares of the particular corporation or a corporation that does not deal at arm's length with the particular corporation principally for the purpose of increasing the total amount of permitted deferrals with respect to qualifying dispositions of the individual and the related persons. Where the rule applies, the permitted deferral with respect to qualifying dispositions of the new shares is deemed to be nil.

Subsection 44.1(12) is amended to apply to the following circumstances:

- when the new shares are issued by a corporation that, at or immediately after the time of issue of the new shares, was a corporation that was not dealing at arm's length with the individual; and

- when the new shares are issued, by a corporation that acquired the old shares (or by another corporation related to that corporation), as part of the transaction or event or series of transactions or events that included that acquisition of the old shares.

This amendment applies to disposition that occur after Announcement Date.

**Clause 20**

**Adjustments to Cost Base**

ITA
53

Section 53 of the Act sets out rules for determining the adjusted cost base (ACB) of property. Certain adjustments are made under this section. Subsection 53(1) provides for additions in computing the ACB of a property, and subsection 53(2) for deductions in computing the ACB of a property.

**Recomputation of Adjusted Cost Base on Transfers and Deemed Dispositions**

ITA
53(4)

Subsection 53(4) of the Act provides rules that affect the computation of the adjusted cost base (ACB) to a taxpayer of any "specified property". As defined in section 54, "specified property" is capital property that is a share, a capital interest in a trust, a partnership interest or an option to acquire any such property. The rules in subsection 53(4) apply where the proceeds of disposition of a specified property are determined under any one of a number of specified provisions in the Act set out in the subsection.

Subsection 53(4) is amended to reflect amendments to a number of those specified provisions; namely, subsections 107(2.1), (4) and (5) of the Act. The references in subsection 53(4) to subsections 107(4) and (5) are removed because those provisions no longer provide for a deemed disposition of trust property. Instead, where subsection 107(4) or (5) applies, a disposition of property will result under paragraph 107(2.1)(*a*). Therefore, the reference to paragraph 107(2.1)(*a*) in subsection 53(4) is sufficient.

This amendment applies after Announcement Date.

**Clause 24**

**Other Sources of Income**

ITA
56 to 59.1

Sections 56 to 59.1 of the Act list some of the types of "other income" that are required by paragraph 3(*a*) of the Act to be included in computing the income of a taxpayer for a taxation year from sources of income (these sources are sources other than the taxpayer's income for the year from each office, employment, business and property).

**Restrictive Covenant - Bad Debt Recovered**

ITA
56(1)(*m*)

New paragraph 56(1)(*m*) of the Act is added to provide that a taxpayer is required to include in income any amount received in a taxation year on account of a debt in respect of which a bad debt deduction was made under new paragraph 60(*f*) of the Act in computing the taxpayer's income for a preceding taxation year. In other words, if a taxpayer makes a bad debt deduction for an amount receivable in respect of a restrictive covenant that was previously included in computing the taxpayer's income because of new section 56.4 (or new subsection 6(3.1)) of the Act, and the taxpayer (or a person not dealing at arm's length with the taxpayer) subsequently receives the amount, the amount so received is to be included in computing the taxpayer's income.

**Government Assistance**

ITA
56(1)(*r*)

Paragraph 56(1)(*r*) requires that certain amounts received as earnings supplements under government sponsored projects or as financial assistance under programs established by the Canada Employment Insurance Commission or under similar programs established by other government entities or organizations pursuant to agreements with the Commission are to be included in computing the recipient's income.

In recent years, there have been a number of income replacement benefits paid under government programs, usually in response to an unforeseen event, or as bridging benefits payable until another program is implemented. These income replacement benefits are

generally paid to individuals who are not eligible for employment insurance (EI) benefits either because they have not worked enough weeks or because they have otherwise exhausted their benefits. However, the benefits paid are generally calculated by reference to the amounts that the individual would receive under the *Employment Insurance Act* if they were eligible for benefits under that Act.

Paragraph 56(1)(*r*) is amended, for the 2003 and subsequent taxation years, to clarify that income replacement benefits received under government assistance programs that are similar to income replacement payments provided under the *Employment Insurance Act* are to be included in computing the recipient's income.

**Clause 24.1**

**Restricted Covenants**

ITA
56.4

New section 56.4 of the Act sets out rules with respect to amounts that are received or receivable in respect of a restrictive covenant. New section 56.4 reflects changes to the income tax law proposed by the Minister of Finance on October 7, 2003 (release 2003-049), and it applies to amounts received or receivable by a taxpayer after October 7, 2003, other than to amounts received by the taxpayer before 2005 under a grant of a restrictive covenant made in writing on or before October 7, 2003 between the taxpayer and a person with whom the taxpayer deals at arm's length.

In addition to new section 56.4, there are consequential changes to other provisions of the Act, including section 6 (employment income), section 56 (amounts to be included in income), section 60 (other deductions), section 68 (allocation of consideration) and section 212 (Part XIII tax, non-resident withholding tax) of the Act. The notes accompanying those consequential changes contain additional details about each change.

**Definitions**

ITA
56.4(1)

New subsection 56.4(1) defines an "eligible interest", a "restrictive covenant" and a "taxpayer" - these definitions are relevant for the purpose of computing the amount, if any, that a taxpayer is required to include in income, or in proceeds of disposition in respect of

certain capital property, in respect of amounts received or receivable for a restrictive covenant.

**"eligible interest"**

"Eligible interest", of a taxpayer, means capital property of the taxpayer that is

- a partnership interest in a partnership that carries on a business, or
- a share of the capital stock of a corporation that carries on a business.

**"restrictive covenant"**

"Restrictive covenant", of a taxpayer, means an arrangement entered into, an undertaking made, or a waiver of an advantage or right by a taxpayer (other than an arrangement or undertaking for the disposition of the taxpayer's property), that affects, in any way whatever, the acquisition or provision of property or services by a taxpayer or by another taxpayer that does not deal at arm's length with the taxpayer.

**"taxpayer"**

"Taxpayer" includes a partnership.

**Income - Restrictive Covenants**

ITA
56.4(2)

New subsection 56.4(2) of the Act provides that there is to be included in computing a taxpayer's income for a taxation year amounts in respect of a restrictive covenant that are received or receivable in the taxation year by the taxpayer (or by a person not dealing at arm's length with the taxpayer). If an amount that is receivable is included because of subsection 56.4(2) in computing a taxpayer's income in a taxation year, the amount will not be included in computing the taxpayer's income in a subsequent year. Subsection 56.4(2) does not apply in certain circumstances described in subsection (3).

**Non-application of Subsection (2)**

ITA
56.4(3)

There are three exceptions to the income inclusion rule in subsection 56.4(2) of the Act for amounts received or receivable in respect of a restrictive covenant granted by a taxpayer to a person with whom the taxpayer deals at arm's length (the "purchaser").

First, subsection 56.4(2) does not apply to an amount if section 5 or 6 of the Act applies to include the amount in computing the taxpayer's income for the year or would have so applied if the amount had been received in the taxation year.

Second, subsection 56.4(2) does not apply to an amount if it is required by the description E in the definition "cumulative eligible capital" in subsection 14(5) of the Act to be taken into account by the taxpayer in computing the taxpayer's cumulative eligible capital in respect of a business. The taxpayer and the purchaser of the restrictive covenant are required to elect in prescribed form to apply this exception. In doing so, they must each include a copy of the form in their income tax return for the taxation year that includes the day on which the restrictive covenant was agreed to and file the return with the Minister on or before the filing-due date for that year.

Third, subsection 56.4(2) does not apply to an amount to the extent that the amount is additional "proceeds of disposition" from the disposition of an eligible interest (see the definition "eligible interest" in subsection 56.4(1)) of the taxpayer if certain conditions are met. For this to be the case:

- The amount must directly relate to the taxpayer's disposition of an eligible interest.

- The disposition of the eligible interest must be to the purchaser of the restrictive covenant (or to a person related to that purchaser).

- The amount received or receivable must be consideration for an undertaking by the taxpayer not to provide property or services in competition with the property or services provided by the purchaser (or by a person related to the purchaser).

- The amount cannot exceed the amount determined by the formula A - B

Where *(see example below)*

A is the amount that would be the fair market value of the taxpayer's eligible interest that is disposed of - if all of the restrictive covenants that may reasonably be considered to relate to the disposition of an interest in the business by any taxpayer were provided for no consideration, and

B is the amount that would be the fair market value of the taxpayer's eligible interest that is disposed of if no covenant were granted by any taxpayer that held an interest in the business.

- The amount is included in the taxpayer's proceeds of disposition of the eligible interest.

And

- The taxpayer and the purchaser of the restrictive covenant elect in prescribed form to apply this exception. In doing so, they must each include a copy of the form in their income tax return for the taxation year that includes the day on which the restrictive covenant was agreed to and file the return with the Minister on or before the filing-due date for that year.

*Example:*

*Assumed facts:*

- *The facts are a variation of those provided in the example included in the Backgrounder to the Minister of Finance's release of October 7, 2003 (2003-049). Both Terence and Isabelle receive $900,000 for selling their 50 shares of X Ltd. to Y Ltd. However, instead of Terence receiving $200,000 for his restrictive covenant, he is to receive $150,000 and Isabelle grants a restrictive covenant to Y Ltd. for which she is to receive $50,000.*

- *The required elections and prescribed forms are filed on time.*

*Application of proposed rules:*

*To Isabelle:*

*Because Isabelle is to receive $50,000 for her restrictive covenant, she may add a portion of those proceeds to the $900,000 she is to receive for the sale of her shares of X Ltd. The portion of the $50,000 that can be added to those share proceeds is the amount*

*by which the value of her share interest would increase if the covenant (and all restrictive covenants that may be reasonably be considered to relate to a disposition of an interest in the business by any taxpayer) were provided for no consideration.*

1. *Capital gain = $950,000 ($950,000 proceeds less nil adjusted cost base)*

   *Where proceeds of disposition are:*

   - *$900,000 in proceeds of disposition for shares of X Ltd.*

   *plus*

   - *$50,000 of the covenant proceeds (which can be added to the proceeds of disposition from the sale of the business), determined as follows:*

   *Lesser of:*

   i. *$50,000 (amount receivable)*

   ii. *$100,000 (value by which Isabelle's share interest in X Ltd. would increase if covenants provided by her and Terence were provided for no consideration when compared with a sale in which no covenant is granted; that is 50% of $200,000), computed as follows:*

   *To the extent*

   - *$1 million (50% of $2 million if covenants for no consideration)*

   *exceeds*

   - *$900,000 (50% of $1.8 million if no covenant granted).*

2. *Ordinary income = $50,000 ($100,000 less $50,000 allocated to proceeds of disposition for shares).*

*To Terence:*

*Because Terence is to receive $150,000 for granting a restrictive covenant, he may add a portion of those proceeds to the $900,000 he is to receive for the sale of his shares of X Ltd. The portion of the $150,000 that can be added to those share proceeds is the amount by which the value of his share interest would increase if the covenant (and all restrictive covenants that may be reasonably*

*be considered to relate to a disposition of an interest in the business by any taxpayer) were provided for no consideration.*

1. *Capital gain = $1 million ($1 million proceeds less nil adjusted cost base)*

*Where proceeds of disposition are:*

- *$900,000 in proceeds of disposition for shares of X Ltd.*

*plus*

- *$100,000 of covenant proceeds (which can be added to the proceeds of disposition from the sale of the business), determined as follows:*

*Lesser of:*

*i. $150,000 (amount receivable)*
*ii. $100,000 (value by which Terence's share interest in X Ltd. would increase if covenants provided by him and Isabelle were provided for no consideration when compared with a sale in which no covenant is granted; that is, 50% of $200,000), computed as follows:*

*To the extent*

- *$1 million (50% of $2 million if covenants for no consideration)*

*exceeds*

- *$900,000 (50% of $1.8 million if no covenant granted).*

2. *Ordinary income = $50,000 ($150,000 less $100,000 allocated to proceeds of disposition for shares).*

**Treatment of Purchaser**

ITA
56.4(4)

New subsection 56.4(4) of the Act provides rules that apply to an amount paid or payable by a purchaser of a restrictive covenant in certain circumstances.

If the amount paid or payable by a purchaser of a restrictive covenant is employment income of an employee of the purchaser, the amount

is considered to be wages paid or payable by the purchaser to the employee.

If the purchaser elected under paragraph (3)(*b*), the amount paid or payable for the restrictive covenant is, for the purposes of applying to the purchaser the definition "eligible capital expenditure" in subsection 14(5) of the Act, to be considered to be an outlay incurred by the purchaser on account of capital.

If the purchaser elected under subparagraph (3)(*c*)(v), and the amount relates to the purchaser's acquisition of property that is, immediately after the acquisition, an eligible interest, the amount that is paid or payable is to be included in computing the cost to the purchaser of that interest.

**Non-application of Section 42**

ITA
56.4(5)

New subsection 56.4(5) of the Act provides that section 42 of the Act does not apply to an amount received or receivable as consideration for a restrictive covenant.

**Clause 25**

**Deductions in Computing Income**

**Restrictive Covenant - Bad Debt**

ITA
60(*f*)

New paragraph 60(*f*) provides a taxpayer with a deduction for a bad debt in respect of an amount that was receivable on a restrictive covenant and previously included in computing the taxpayer's income because of new section 56.4 (or new subsection 6(3.1)) of the Act. This amendment applies after October 7, 2003.

**Transfers of Refund of Premiums under RRSP**

ITA
60(*l*)

Section 60 of the Act provides for various deductions in computing income.

When an individual who is a spouse, common-law partner or financially dependent child or grandchild of another person receives, on the death of that person, a distribution from a registered retirement savings plan (RRSP) or registered retirement income fund (RRIF) under which that person was the annuitant, the individual is required to include the amount in income. However, paragraph 60(*l*) of the Act provides an offsetting deduction if the amount is used within a specified period of time to acquire an annuity described in subparagraph 60(*l*)(ii). (Under certain circumstances, the amount may also be paid into an RRSP or RRIF.)

There are two basic types of annuity described in subparagraph 60(*l*)(ii). The first (described in clause 60(*l*)(ii)(A)) is a life annuity (or an annuity payable to age 90), under which the individual is the annuitant. Where the individual is a child or grandchild of the deceased RRSP or RRIF annuitant, a deduction for this type of annuity is available only if the child or grandchild was dependent on the deceased by reason of physical or mental infirmity. The second (described in clause 60(*l*)(ii)(B)) is an annuity payable for a fixed number of years not exceeding 18 minus the individual's age in years at the time the annuity is acquired. In this case, the annuitant can be either the individual or a trust under which the individual is the sole person beneficially interested in amounts payable under the annuity.

Paragraph 60(*l*) is amended in two ways. First, clause 60(*l*)(ii)(A) is amended to allow (as is the case in clause 60(*l*)(ii)(B)) a trust to be named as the annuitant under the annuity. This option will be available if the individual is mentally infirm and is the sole person beneficially interested in amounts payable under the annuity. The latter requirement applies only while the individual is alive, thus ensuring that provision can be made for any residual amounts that remain in the trust after the individual's death.

This amendment applies to taxation years that end after 2000, except that, for those taxation years that end before 2004, the option to use a trust will also be available for individuals who are physically infirm.

Second, clause 60(*l*)(ii)(B) is amended to ensure consistency with amended clause 60(*l*)(ii)(A) in describing the trust option. Specifically, the requirement that the individual be the sole person

beneficially interested in amounts payable under the annuity is modified so that it no longer applies after the individual's death.

This amendment applies to taxation years that end after 1988, which reflects the introduction of the trust option for minor children.

**Clause 30.1**

**Allocation of Amounts in Consideration for Property, Services or Restrictive Covenants**

ITA
68

Section 68 of the Act applies where an amount received or receivable can reasonably be regarded as being in part consideration for the disposition of a particular property of a taxpayer or as being in part consideration for the provision of particular services. If the amount is in part consideration for the disposition of property, that part of the consideration that can reasonably be regarded as being for the disposition of property is deemed to be the proceeds of disposition of that property and, reciprocally, the cost of the property for the acquirer. If the amount is in part consideration for the provision of particular services, that part of the consideration that can reasonably be regarded as being for the provision of particular services is deemed to be an amount received or receivable by the taxpayer in respect of those services and, reciprocally, an amount paid or payable by the person to whom the services are rendered.

Section 68 is amended to apply in circumstances where consideration received or receivable by a taxpayer is in part for a restrictive covenant (as defined by new subsection 56.4(1) of the Act) agreed to by the taxpayer. In such a case, the part of the consideration that can reasonably be regarded as being for the restrictive covenant is considered to be an amount that is received or receivable by the taxpayer in respect of the restrictive covenant, and that part is also considered to be paid or payable to the taxpayer by the person to whom the restrictive covenant was granted.

The change applies on and after Announcement Date, other than to a taxpayer's grant of a restrictive covenant made in writing before Announcement Date between the taxpayer and a person with whom the taxpayer deals at arm's length.

## Clause 31.1

### Death of a Taxpayer

ITA
70

Section 70 of the Act deals in particular with the transfer or distribution of property at the time of the death of a taxpayer. The French version of subsections 70(3), (6), (6.1), (7), (9), (9.1), (9.2) and (9.3) is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the taxpayer's beneficiaries and not simply set aside for them. Stylistic changes have also been made to these subsections. The amendments will come into force on Royal Assent.

## Clause 31.2

### Election by Legal Representative and Transferee re Reserves

ITA
72(2)

Subsection 72(2) of the Act sets out the rules that apply in instances where the property of a deceased taxpayer that has a right to receive any amount is transferred or distributed to the taxpayer's spouse or common-law partner or to a trust. The French version of this subsection is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or her. Stylistic changes have also been made to the French version of this subsection. The amendments will come into force on Royal Assent.

## Clause 32

### *Inter Vivos* Transfers by Individuals

ITA
73

Section 73 of the Act provides rules for the tax treatment of certain *inter vivos* transfers of property.

**Capital Cost and Amount Deemed Allowed**

ITA
73(2)

Subsection 73(2) of the Act applies where a person ("transferor") transfers depreciable capital property ("DCP") of a prescribed class to a taxpayer ("transferee") in circumstances in which subsection 73(1) applies. If the capital cost to the transferor of the DCP is greater than the amount at which the transferee is deemed under subsection 73(1) to have acquired the DCP, subsection 73(2) ensures that the proper amount of capital cost allowance allowed to the transferor is available for recapture on a subsequent disposition of the DCP by the transferee.

Subsection 73(2) of the Act is amended to replace the reference to paragraph 73(1)(*e*) with a reference to paragraph 73(1)(*b*). Paragraph 73(1)(*b*) now provides for the amount at which the transferee is deemed to acquire property on a transfer to which subsection 73(1) applies.

This amendment applies to transfers that occur after 1999.

**Clause 32.1**

**Compensation Payments Deductible by Individuals**

ITA
82(1)(*a*)(ii)(B)

Clause 82(1)(*a*)(ii)(B) of the Act allows an individual who has entered into a securities lending arrangement to deduct, to the extent of the individual's dividend income, the dividend compensation payment paid by the individual.

Due to the amendments made to the securities lending arrangement rules in section 260 of the Act, clause 82(1)(*a*)(ii)(B) is amended in two ways. First, it is amended to apply in respect of an individual's specified proportion of a dividend compensation payment made by a partnership of which the individual is a member. Secondly, since new subsection 260(5.1) of the Act now sets out the treatment of dividend compensation payments, the clause is amended to replace the reference to "subsection 260(5)" with a reference to "subsection 260(5.1)".

Whether this amendment applies in respect of a particular securities lending arrangement depends on when the arrangement is made and,

in the case of an arrangement made after November 2, 1998 and before December 21, 2002, whether the parties to the arrangement have elected to have the amended definition of "dividend rental arrangement" in subsection 248(1) of the Act apply. The following table shows these alternative results.

| | **Date Arrangement Was Made** | | | |
|---|---|---|---|---|
| | *Before November 3, 1998* | *After November 2, 1998 and before 2002* | *After 2001 and before December 21, 2002* | *After December 20, 2002* |
| **Election made** | Election not available. Amendment does not apply | Amendment applies, but read reference to 260(5.1) as a reference to 260(5) | Amendment applies | Election not available. Amendment applies |
| **Election not made** | Election not available. Amendment does not apply | Amendment does not apply | Amendment applies, but ignore reference to 260(12)(*b*) | Election not available. Amendment applies |

## Clause 32.2

## Deemed Dividend

ITA
84(4.1)

Subsection 84(4.1) of the Act treats a payment on a reduction of paid-up capital by a public corporation as a dividend, except where the payment is made by way of a redemption, acquisition or cancellation of a share or in the course of a transaction described in subsection 84(2) or section 86 of the Act.

Subsection 84(4.1) is amended to introduce a new exception. Generally, this exception will apply where the amount paid on a reduction of paid-up capital may reasonably be considered to be a distribution of proceeds realized from a transaction or event that did not occur in the ordinary course of the corporation's business and those proceeds were derived from a transaction or event that occurred no more than 24 months before the return of the paid-up capital.

In the case of a transaction or event that funds the payment, generally relief from the deemed dividend rule in subsection 84(4.1) will apply

if the paid-up capital distribution can be traced to proceeds realized in connection with a transaction or event that may reasonably be considered to be derived from a transaction that occurs outside of the ordinary course of the corporation's business. For example, a paid-up capital distribution paid out of proceeds realized on the sale of a business unit of a corporation, where the proceeds were not required for reinvestment, would generally not be considered to be a distribution from amounts realized in the ordinary course of the corporation's business. In general terms, this aspect of the amendment to subsection 84(4.1) is intended to ensure that only a return of corporate capital, as opposed to a distribution of earnings, is subject to the new exception to subsection 84(4.1).

In order to ensure that the proceeds from an extraordinary transaction are not used to fund a stream of regular or periodic distributions, only one return of paid-up capital will be permitted in respect of any particular extraordinary transaction and that return must occur within 24 months of the proceeds being realized. However, this one-time return rule and 24 month limitation will not apply to distributions of paid-up capital made after 1996 and before Announcement Date.

## Clause 33

## Transfer of Property to a Corporation By Shareholders

ITA
85(1)(*d*.1), (*d*.11) and (*d*.12)

Subsection 85(1) of the Act provides a tax deferral for the transfer of various types of property by a taxpayer to a taxable Canadian corporation for consideration that includes shares of the corporation's capital stock. In general, tax deferral may be achieved if the taxpayer and the corporation jointly elect that the proceeds of disposition of the taxpayer and the eligible capital expenditure of, or cost to, the corporation are deemed to be less than the fair market value of the property transferred.

Paragraph 85(1)(*d*.1) generally reduces, for the corporation that has acquired an eligible capital property (ECP), the gain that would be included in income under paragraph 14(1)(*b*) of the Act on a subsequent disposition of the property. Paragraph 85(1)(*d*.1) adjusts the gain, in order to take into account the 1988 change of the rate of income inclusion and expenditure deductibility from 1/2 to 3/4, by adjusting the calculation of variable Q in the definition "cumulative eligible capital" in subsection 14(5) of the Act. Variable Q generally represents, for the period prior to the taxpayer's "adjustment time", the difference between ECP deductions claimed under paragraph

20(1)(*b*) of the Act and the total of recapture and gains from prior dispositions of eligible capital property by the taxpayer. Paragraph 85(1)(*d*.1) adjusts variable Q only for the purposes of calculating the amount to be included in a corporation's income under paragraph 14(1)(*b*), but not for the purpose of calculating the corporation's cumulative eligible capital balance for other purposes, such as the claiming of ECP deductions. Specifically, the adjustment of variable Q adjusts the value of variables A, B and C in the formula in paragraph 14(1)(*b*). Variables A and B are affected indirectly, since variable Q affects variable F in the calculation of the cumulative eligible capital balance.

Paragraph 85(1)(*d*.1) is amended concurrently with the addition of new paragraph 85(1)(*d*.11) of the Act. New paragraph 85(1)(*d*.11) generally applies to ensure that an amount that would have been recaptured ECP deductions to the taxpayer under subsection 14(1), if the taxpayer had disposed of the eligible capital property for an amount greater than the taxpayer's cumulative eligible capital at the time of the disposition, is subject to recapture in the hands of the corporation upon a subsequent sale of the property. This result is achieved by adding an allocation of the potential recapture to the taxpayer (i.e., variable F of the taxpayer) simultaneously to the corporation's eligible capital expenditures and aggregate ECP deductions (i.e., variables A and F respectively in the definition "cumulative eligible capital" of the corporation). This adjustment applies only for the purpose of calculating the amount to be included in income of the corporation under subsection 14(1) upon the subsequent disposition of eligible capital property. In this regard, variable F of the taxpayer is determined at the beginning of the taxpayer's following taxation year if the taxpayer's taxation year that included the transfer had ended immediately after the disposition time, determined without reference to new paragraph (*d*.12). Variable F of the taxpayer is apportioned to the corporation in the same proportion as the fair market value of the property transferred is to the fair market value of total eligible capital property of the taxpayer immediately before the transfer.

Because new paragraph 85(1)(*d*.11) now accommodates variable F of the corporation, paragraph 85(1)(*d*.1) is amended to add 1/2 of the taxpayer's variable Q amount directly to the corporation's variable C amount in paragraph 14(1)(*b*), rather than adjusting variable Q of the corporation (and thus variable F as well).

New paragraph 85(1)(*d*.12) of the Act is added, concurrently with new paragraph 85(1)(*d*.11), to ensure that a subsequent disposition of other ECP by the taxpayer does not result in recapture of depreciation under paragraph 14(1)(*a*) when the resulting gain from that disposition should have been taxed at a lower rate under paragraph

14(1)(*b*). This could happen, for instance, if the taxpayer were to defer all of the recapture to the corporation, such that the taxpayer's cumulative eligible capital balance at the end of the taxation year that includes the rollover is nil. In this case, if in the next taxation year the taxpayer were to make another disposition of ECP, paragraph 85(1)(*d*.12) would reduce to nil the amounts that would be determined for the taxpayer by subparagraph 14(1)(*a*) and variable B of paragraph 14(1)(*b*).

These amendments apply in respect of dispositions that occur after Announcement Date.

***Example of 85(1)(d.1) and (d.11)***

*Mr. X purchased an eligible capital property in 1984 (when the income inclusion rate for eligible capital property was one half) at a cost of $300,000. This was the first and only eligible capital property held in respect of his business. Mr. X claimed deductions of $40,650 under paragraph 20(1)(b) of the Act before his "adjustment time" (in the case of Mr. X, January 1, 1988), and of $11,482 subsequent to that time. Mr. X now transfers the property to a corporation in circumstances to which subsection 85(1) applies. Immediately before the time of the transfer, the fair market value of the property is $500,000. Mr. X and the corporation agree that the proceeds of disposition to Mr. X will be $203,391, which is 4/3 of the cumulative eligible capital balance of $152,543. The balance is calculated as follows:*

| | |
|---|---|
| *Eligible capital expenditure* | *$300,000* |
| *Rate applicable in 1984* | *50%* |
| | *150,000* |
| *Depreciation before 1988* | *< 40,650>* |
| *Cumulative eligible capital at adjustment time* | *109,350* |
| *"C" amount: 3/2 of 109,350* | *164,025* |
| *"D" amount: depreciation before 1988* | *40,650* |
| *"P" amount: depreciation after 1987* | *<11,482>* |
| *"Q" amount: depreciation before 1988* | *<40,650>* |
| *Cumulative eligible capital of Mr. X* | *$152,543* |

*Upon the subsequent sale of the property by the corporation for actual proceeds of disposition of $500,000, the amount included in the corporation's income under subsection 14(1) is calculated as follows:*

| | | | |
|---|---|---|---|
| *Agreed amount of eligible capital expenditure (4/3 of $152,543)* | | *$203,391* | |
| *Eligible capital expenditure rate* | | *75%* | |
| *"A" amount in cumulative eligible capital balance of corporation* | | *152,543* | |

*14(1)(a) calculation for corporation:*

| | | | |
|---|---|---|---|
| *Proceeds* | *$500,000* | | |
| *Rate applicable* | *75%* | | |
| *"E" amount in cumulative eligible capital balance of corporation* | | *375,000* | |
| *Excess* | | *222,457* | |
| *"F" for corporation: bumped by 85(1)(d.11) ($40,650 + $11,482)* | | *52,132* | |
| *14(1)(a) income: lesser of "F" and excess* | | | *$52,132* |

*14(1)(b) calculation for corporation:*

| | | |
|---|---|---|
| *Excess (as above)* | *$222,457* | |
| *Less: "B" amount: amount "F", as bumped by 85(1)(d.11)* | *<52,132>* | |
| *"C" amount: ½ of "Q" (above), as bumped by 85(1)(d.1)* | *<20,325>* | |
| *Net* | *150,000* | |
| *multiply by 2/3* | *2/3* | |
| *14(1)(b) income* | | *$100,000* |
| | | |
| *Total 14(1) income inclusion to corporation* | | *$152,132* |

**Clause 36**

**Winding-up of a Corporation**

ITA
88(1.1)(*e*)

Subsection 88(1.1) of the Act allows a parent corporation under certain circumstances to use losses of a subsidiary corporation that has been wound up. Paragraph 88(1.1)(*e*) limits the use that can be made of the former subsidiary's non-capital losses and farm losses where either the parent or the subsidiary has undergone an acquisition

of control. In its current form, the paragraph applies these limits regardless of when the acquisition of control took place. This can produce results that are unnecessarily restrictive. If, for example, a newly-acquired corporation is made the parent of an existing subsidiary that has losses, but the subsidiary itself has not undergone an acquisition of control since it incurred those losses, there is no reason for paragraph 88(1.1)(*e*) to limit the use that the parent corporation can make of the subsidiary's losses after the winding-up.

To ensure that it applies more appropriately, paragraph 88(1.1)(e) is amended to distinguish between acquisitions of control of the parent corporation and acquisitions of control of the subsidiary. In respect of the parent, the limits imposed by the provision will apply only where a person or group of persons has acquired control after the commencement of the winding-up. In respect of the subsidiary, those limits will continue to apply if control has been acquired at any time.

Amended paragraph 88(1.1)(e) applies to windings-up that begin after May 1996.

**Clause 38.1**

**Application of Certain Provisions to Trusts Not Resident in Canada**

ITA
94(1)

Paragraph 94(1)(*c*) of the Act deals with the case where an amount of the income or the capital of a trust is to be distributed to a beneficiary of the trust. The French version of this paragraph is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or her. This amendment will come into force on Royal Assent.

**Definitions**

ITA
95(1)

**"relevant tax factor"**

[The proposed measure concerning this definition that was included with the legislative proposals released in December 2002 has been removed from these proposals and incorporated in the "Legislative

Proposals Relating to the Income Tax Act (Taxation of Non-Resident Trusts and Foreign Investment Entities)" announced on October 30, 2003.]

## Agreement or Election of Partnership Members

ITA
96(3)

[this explanatory note is deleted]

## Clause 42

## Trusts and Their Beneficiaries

## Deemed Disposition and Election

ITA
104(4) and (5.3)

Paragraphs 104(4)(*a*.2) and (5.3)(*b*.1) of the Act deal with cases where a trust distributes property to a beneficiary. The French version of these paragraphs is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or her. These amendments will come into force on Royal Assent.

## Designation in Respect of Taxable Dividends

ITA
104(19)

Subsection 104(19) of the Act permits a trust to designate a taxable dividend received by it in a taxation year on the share of a taxable Canadian corporation. Where the designation is made in respect of a beneficiary under the trust, the dividend is treated, for the purposes of the Act (other than Part XIII), as a taxable dividend received by the beneficiary from the corporation, and is treated, for the purposes of the dividend gross-up in paragraph 82(1)(*b*) and stop-loss rules in paragraphs 107(1)(*c*) and (*d*) and section 112, as not having been received by the trust.

Subsection 104(19) is amended to clarify that where a designation, in respect of a taxpayer, is made by a trust in respect of a taxable dividend received by the trust in a particular taxation year of the trust, on a share of the capital stock of a taxable Canadian

corporation, the portion of the dividend in respect of which the designation is made is

- for the purposes of paragraphs 82(1)(*b*) and 107(1)(*c*) and (*d*) and section 112, deemed not to have been received by the trust, and

- for the purposes of the Act other than Part XIII, deemed to be a taxable dividend on the share received by the taxpayer in the taxpayer's taxation year in which the particular taxation year of the trust ends.

These deeming rules do not apply, however, unless a number of conditions are met. One of these conditions - that a designated amount not be made in respect of more than one beneficiary under the trust - is replaced with a new requirement that the total of all amounts designated by the trust under subsection 104(19) for the particular taxation year of the trust not exceed the total of all amounts each of which is the amount of a taxable dividend received by the trust in the particular taxation year on a share of the capital stock of a taxable Canadian corporation.

This amendment applies to taxation years that end after Announcement Date.

**Designation in Respect of Taxable Capital Gains**

ITA
104(21)

Subsection 104(21) of the Act permits a trust to designate, in respect of a beneficiary under the trust, a portion of its net taxable capital gains. Where the designation is made, the amount designated is deemed, for the purposes of sections 3 and 111 (except as they apply for the purposes of determining whether a beneficiary is entitled to claim a capital gains exemption under section 110.6), to be a taxable capital gain for the year of the beneficiary from the disposition of capital property.

Subsection 104(21) is amended to clarify that where a designation, in respect of a taxpayer, is made by a trust in respect of its net taxable capital gains for a particular taxation year of the trust, the designated amount is deemed to be a taxable capital gain, for the taxation year of the taxpayer in which the particular taxation year ends, from the disposition by the taxpayer of capital property.

The deeming rule does not apply, however, unless a number of conditions are met. One of these conditions - that a designated amount not be made in respect of more than one beneficiary under

the trust - is replaced with a new requirement that the total amounts designated under subsection 104(21) by the trust for a particular taxation year of the trust not exceed the trust's net taxable capital gains for the particular taxation year.

Subsection 104(21) is also amended to clarify that the deeming rule does not apply to a designation made by a trust, for a particular taxation year of the trust, in respect of a non-resident beneficiary, unless the trust is a mutual fund trust throughout the particular taxation year.

These amendments apply to taxation years that end after Announcement Date.

**Deemed Gains - Subsection (21.4) Applies**

ITA
104(21.6)

Subsection 104(21.6) of the Act provides rules for the determination of the inclusion rate to be used by a taxpayer for capital gains realized by a trust in 2000. This subsection applies to a taxpayer who has a taxation year that begins after October 17, 2000 and who is deemed by subsection 104(21.4) to have capital gains from the disposition of capital property in the year in respect of dispositions of property by a trust of which the taxpayer is a beneficiary.

This subsection ensures that the inclusion rate for capital gains realized on property disposed of by a trust prior to February 27, 2000 is 3/4, and is 2/3 in respect of property disposed of by a trust after February 27, 2000 and before October 18, 2000.

Subsection 104(21.6) is amended by adding new paragraph (*f*.1) to ensure that where the deemed gains are in respect of capital gains from dispositions of property by the trust that occurred after February 27, 2000 and before October 17, 2000 in circumstances where the taxation year of the taxpayer began after February 27, 2000 and ended after October 17, 2000, the gains are deemed to be a capital gain of the taxpayer from the disposition by the taxpayer of capital property in the taxpayer's taxation year and in the period that began after February 27, 2000 and ended before October 18, 2000.

Paragraph 104(21.6)(*g*) is amended to correct a technical deficiency in a reference to a date. The reference to "October 17, 2000" is changed to "October 18, 2000" which reflects the date on which the reduction of the capital gain inclusion rate from 2/3 to 1/2 was announced.

This amendment applies to taxation years that end after February 27, 2000.

**Designation in Respect of Foreign Income**

ITA
104(22)

Subsection 104(22) of the Act permits a trust to designate, in respect of a beneficiary under the trust, an amount of its foreign income. Such a designation is made by the trust on a source-by-source basis. Where the designation is made, the amount designated is deemed, for the purpose of subsections 104(22) and (22.1) and section 126, to be the beneficiary's income for the year from that source.

Subsection 104(22) is amended to clarify that where an amount is designated, in respect of a taxpayer, by a trust in respect of the trust's income for a particular taxation year of the trust from a source in a country other than Canada, the designated amount is deemed to be income of the taxpayer, for the taxation year of the taxpayer in which the particular taxation year of the trust ends, from that source.

The deeming rule does not apply, however, unless a number of conditions are met. One of these conditions - that a designated amount not be made in respect of more than one beneficiary under the trust - is replaced with a new requirement that the total amounts designated, in respect of the trust's income from a particular foreign source, under subsection 104(22) by the trust for a particular taxation year of the trust not exceed the trust's income for the particular taxation year from that source.

These amendments apply to taxation years that end after Announcement Date.

**Amounts Deemed Payable to Beneficiaries**

ITA
104(29)

[this explanatory note is deleted]

**Clause 42.1**

**Proceeds of Disposition of Income Interest**

ITA
106(3)

Subsection 106(3) of the Act stipulates that the trust that distributes any property to its beneficiary in satisfaction of the taxpayer's interest in the income of the trust is deemed to have disposed of the property for proceeds of disposition equal to the fair market value of the property. The French version of this subsection is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or her. This amendment will come into force on Royal Assent.

**Clause 43**

**Interests in Trusts**

**Cost Reduction Rule**

ITA
107(1)(*e*)

Subsection 107(1) of the Act contains special rules applicable to the disposition of an interest in a trust. A trust can distribute non-taxable amounts, such as returns of capital and the non-taxable portion of a capital gain, to the holders of interests in the trust. Currently, the Act requires a return of capital to be accounted for by reducing the recipient's adjusted cost base of the interest in the trust. While the effect of this general rule is clear where the interest is held as capital property, it is not as clear where the property is held as inventory.

New paragraph 107(1)(*e*) applies when an interest in a trust that is not held as capital property is disposed of. The paragraph deems the cost amount of that interest to be the cost amount used for inventory valuation purposes less the total of all returns of capital and non-taxable capital gains received prior to the disposition. This is to recognize that all receipts for a property held on income account should be treated as either income or a reduction in the cost of the property to the holder.

The new paragraph applies to dispositions after 2001 if the trust interest is a security that is the subject of a securities lending arrangement as defined in section 260 of the Act. Otherwise, the new

rule applies to dispositions after Announcement Date, except that it will not apply to a disposition to take place between Announcement Date and before 2005, if the taxpayer has on or before Announcement Date entered into an agreement in writing for the disposition of the interest.

**Inventory Valuation - Deemed Fair Market Value**

ITA
107(1.2)

Where an interest in a trust is held as an inventory, the fair market value of the interest at valuation for the purpose of section 10 of the Act can be affected by non-taxable distributions from the trust, potentially producing a tax loss to the holder of the interest even though the holder had suffered no economic loss (thanks to the non-taxable distribution the holder has already received).

New subsection 107(1.2) requires that at any particular valuation time the fair market value of an interest in a trust be deemed to be the total of the fair market value otherwise determined and the sum of any returns of capital and non-taxable capital gains payable before that time.

The new paragraph applies to valuations of trust interest that take place after Announcement Date, and to valuations after 2001 if the trust interest in question is a security that is the subject of a securities lending arrangement.

**Distribution by Personal Trust**

ITA
107(2)

Subsection 107(2) of the Act applies where a personal trust or a prescribed trust described in section 4800.1 of the Regulations distributes property to a beneficiary and there is a resulting disposition of part or all of the beneficiary's capital interest in the trust. Under paragraph 107(2)(*a*), the trust is deemed to have disposed of the property for proceeds of disposition equal to the property's cost amount. Under paragraph 107(2)(*b*), the property is deemed to have been acquired by the beneficiary for an amount equal to the total of the amount described in paragraph 107(2)(*a*) and a "bump" equal to the specified percentage of any excess of the adjusted cost base to the beneficiary of the capital interest over its cost amount (as defined by subsection 108(1) of the Act) to the beneficiary of the interest. Under subparagraph 107(2)(*b*.1)(iii), the specified percentage for property (other than non-depreciable capital

property and eligible capital property) is 75%. Where subsection 107(2) applies, paragraph 107(2)(*c*) provides that the beneficiary is deemed to have disposed of all or part, as the case may be, of the capital interest for proceeds equal to the amount determined under that paragraph.

Subparagraph 107(2)(*b*.1)(iii) is amended to replace the reference to 75% with a reference to 50%, consistent with the current capital gains inclusion rate.

This amendment applies to distributions, from a trust, made after December 20, 2002.

Paragraph 107(2)(*c*) is amended to clarify that it applies to determine a taxpayer's proceeds of disposition of the capital interest in a trust (or of the part of it) disposed of by the taxpayer on a distribution, to which subsection 107(2) applies, of property by the trust.

This amendment applies to distributions, from a trust, made after 1999.

Paragraph 107(2)(*d*.1) determines the tax consequences of the disposition of taxable Canadian property by a trust to a non-resident beneficiary before October 2, 1996. In the event that the property was explicitly deemed to have been taxable Canadian property under a number of specified provisions of the Act, paragraph 107(2)(*d*.1) ensures that it continues to be taxable Canadian property of the beneficiary.

Paragraph 107(2)(*d*.1) is amended by adding to the list of specified provisions, that explicitly deem property to be taxable Canadian property, a reference to subsection 85.1(5) of the Act.

This amendment applies in determining after October 1, 1996 whether property is taxable Canadian property.

**Distribution of Property Received on Qualifying Disposition**

ITA
107(4.2)

New subsection 107(4.2) of the Act prevents a tax-deferred distribution of property after December 20, 2002 from a personal trust or a trust prescribed for the purpose of subsection 107(2) of the Act to a beneficiary of the trust if specified conditions are met. The specified conditions are that:

- at a particular time before December 21, 2002 there was a qualifying disposition (within the meaning assigned by subsection 107.4(1) of the Act) of the property, or of other property for which the property is substituted, by a particular partnership or a particular corporation, as the case may be, to any trust; and

- the beneficiary is neither the particular partnership nor the particular corporation.

Where the specified conditions are met, subsection 107(2.1) will apply so that the trust is deemed to have disposed of the property for proceeds equal to the property's fair market value at the time of distribution.

This amendment applies to distributions, from a trust, that are made after December 20, 2002.

**Distribution of Property to a Non-Resident Beneficiary**

ITA
107(5)

Subsection 107(5) of the Act applies to the distribution of property (other than shares in non-resident-owned investment corporations or property described in any of subparagraphs 128.1(4)(*b*)(i) to (iii)) of the Act) by a trust resident in Canada to a non-resident beneficiary. In these circumstances, the rollover under subsection 107(2) is not available and instead subsection 107(2.1) of the Act will apply to determine the Canadian income tax consequences of the distribution to the trust and the beneficiary.

Subsection 107(5) is amended so that it applies whether the trust making the distribution is resident in Canada or not.

This amendment applies to distributions made after Announcement Date.

**Amendments to French Version of Section 107**

ITA
107

Subsections 107(2), (2.001), (2.002), (2.01), (2.1), (2.11), (2.2), (4), (4.1), (5) and (5.1) of the Act deal with distributions by trusts. The French version of these subsections is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or

her. Stylistic changes have also been made to the French versions of these subsections. The amendments will come into force on Royal Assent.

### Clause 43.1

### Distribution by Employee Trust, Employee Benefit Plan or Similar Trust

ITA
107.1

Section 107.1 of the Act prescribes the rules that apply where an employee trust, a trust governed by an employee benefit plan or trust described in paragraph (*a*.1) of the definition "trust" in subsection 108(1) distributes any property to its beneficiary in satisfaction of any part of the beneficiary's interest in the trust. The French version of this section is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or her. The amendments will come into force on Royal Assent.

### Clause 43.2

### Distribution by a Retirement Compensation Arrangement

ITA
107.2

Section 107.2 of the Act prescribes the rules that apply where a trust governed by a retirement compensation arrangement distributes any property to its beneficiary in satisfaction of any part of the taxpayer's interest in the trust. The French version of this section is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or her. Stylistic changes have also been made to the French version of this section. The amendments will come into force on Royal Assent.

**Clause 44**

**Qualifying Disposition**

ITA
107.4(1)

Subsection 107.4(3) of the Act generally provides for a rollover of property to a trust where the property is transferred to the trust by way of a qualifying disposition. For this purpose, subsection 107.4(1) defines "qualifying disposition" to be a disposition of property to a trust that does not result in any change in the beneficial ownership of the property and that otherwise meets the conditions set out in that subsection. A partnership, corporation or individual (including a trust) are all qualified transferors for the purpose of applying the definition "qualifying disposition" in subsection 107.4(1). Where the transferee trust is a non-resident trust, a qualifying disposition will occur only where the conditions in paragraph 107.4(1)(*c*) are satisfied. Another condition that must be met for there to be a qualifying disposition is found in paragraph 107.4(1)(*d*), which requires that the disposition not be by a partnership, if the disposition is part of a series of transactions or events that begins after December 17, 1999 and includes the cessation of the partnership's existence and a subsequent distribution from a personal trust to a former member of the partnership in circumstances to which subsection 107(2) of the Act applies.

Subsection 107.4(1) is amended so that after December 20, 2002 only an individual (including a trust) may make a qualifying disposition to a trust. As a result, paragraph 107.4(1)(*d*) is repealed.

These amendments are deemed to come into force on December 20, 2002. For a related amendment, see the commentary to new subsection 107(4.2) of the Act.

In addition, paragraph 107.4(1)(*c*) is amended so that a qualifying disposition can only be made where the transferee trust is resident in Canada at the time of the transfer. This amendment applies to dispositions that occur after Announcement Date.

ITA
107.4(1)(*g*)

The French version of paragraph 107.4(1)(*g*) of the Act has been amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply

set aside for him or her. This amendment will come into force on Royal Assent.

ITA
107.4(3)

Subsection 107.4(3) of the Act provides a number of income tax consequences that apply in respect of a "qualifying disposition" (as defined in subsection 107.4(1) of the Act) of property to a trust. Paragraph 107.4(3)(*f*) ensures that, in the event that the property was explicitly deemed to have been taxable Canadian property under a number of specified provisions of the Act, the property continues to be taxable Canadian property of the trust.

Paragraph 107.4(3)(*f*) is amended by adding to the list of specified provisions, that explicitly deem property to be taxable Canadian property, a reference to paragraph 44.1(2)(*c*) and to subsection 85.1(5) of the Act.

This amendment applies to dispositions that occur after December 23, 1998, and also applies in respect of the 1996 and subsequent taxation years, to transfers of capital property that occurred before December 24, 1998.

**Clause 45**

**Taxation of Trusts and Their Beneficiaries**

**Definitions**

ITA
108(1)

**"testamentary trust"**

Subsection 108(1) of the Act defines "testamentary trust" generally as a trust or estate that arose on and in consequence of the death of an individual, and provides some exceptions to that definition.

Subsection 104(1) of the Act provides that references to a "trust" in subdivision k (i.e., sections 104 to 108) of Division B of Part I of the Act include a trust or estate. The definition "testamentary trust" in subsection 108(1) is therefore amended to remove the reference to "estate" because the references in that definition to a "trust" include an estate. For more detail, see the commentary to subsection 104(1).

New paragraph (*d*) of the definition "testamentary trust" is an anti-avoidance rule. That new paragraph provides that a testamentary trust in a taxation year does not include a trust (in the commentary on this amendment, references to "trust" include an estate) that incurs, after December 20, 2002 and before the end of the taxation year, a debt or any other obligation to pay an amount to, or guaranteed by, a beneficiary or any other person or partnership (referred to in this commentary as the "specified party") with whom any beneficiary of the trust does not deal at arm's length. However, such a debt will not affect the status of the trust as a testamentary trust if it is a debt or other obligation owed to the specified party and

- it is incurred by the trust in satisfaction of the specified party's right as a beneficiary under the trust to enforce payment of an amount of income or capital gains payable by the trust to the specified party or to otherwise receive any part of the capital of the trust,

- it arose because of a service (for greater certainty, not including any transfer or loan of property) rendered by the specified party to, for or on behalf of the trust; for example, this would include debts or other obligations arising in respect of services rendered in a person's capacity as an executor or administrator of an estate, as a liquidator of succession or as a trustee of a the trust, or

- it arose because of a payment made by the specified party for or on behalf of the trust; for example, a payment of funeral expenses on behalf of the deceased's estate. However, to qualify under this provision, additional conditions must be satisfied. In very general terms, these conditions are that the trust fully reimburse the specified party within a year of the specified party making the payment. More precisely, in exchange for the payment the trust must transfer a property to the specified party within 12 months after the specified party made the payment (or, where written application has been made to the Minister by the trust within that 12 months, within any longer period that the Minister considers reasonable in the circumstances). It must also be reasonable to conclude that the specified party would have been willing to make the payment if the specified party dealt at arm's length with the trust.

These amendments apply to trust taxation years that end after December 20, 2002.

### French Version of the Definitions "cost amount", "trust" and "eligible offset"

ITA
108(1)

The French version of the definitions of "cost amount", "trust" and "eligible offset" in subsection 108(1) of the Act is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or her. These amendments will come into force on Royal Assent.

## Clause 47

### Charitable Donations Deduction

ITA
110.1

Section 110.1 of the Act provides a deduction in computing taxable income in respect of gifts made by corporations to registered charities and to certain other entities. Section 110.1 is amended to expand the entities referred to in this section to include municipal or public bodies performing a function of government in Canada. This amendment is in response to the Quebec Court of Appeal decision in *Tawich Development Corporation* v. *Deputy Minister of Revenue of Quebec*, 2001 D.T.C. 5144. For additional information, see the commentary to paragraph 149(1)(*d*.5).

Section 110.1 is also amended as a consequence of the addition of new subsections 248(30) to (38) of the Act. Generally, those subsections clarify the circumstances under which a transfer of property will be considered a gift notwithstanding that the transferor may be entitled to receive an advantage or benefit in respect of the property. New subsection 248(30) generally provides that the "eligible amount" of the gift is the excess of the fair market value of a property transferred by way of gift over the value of the advantage or benefit, if any, to which the transferor is entitled. For additional information, see the commentary to new subsections 248(30) to (38).

## Deduction for Gifts

ITA
110.1(1)

Paragraphs 110.1(1)(*a*) to (*d*) of the Act provide, respectively, for the deduction by a corporation of amounts in respect of "charitable gifts", "gifts to Her Majesty", "gifts to institutions" and "ecological gifts". The amount deductible by the corporation is generally the fair market value of the gift. These paragraphs are amended, consequential to the addition of new subsection 248(30) of the Act, to provide that the amount deductible by the corporation is generally the "eligible amount" of a gift.

In addition, paragraphs 110.1(1)(*a*) and 110.1(1)(*d*) are expanded to provide that a deduction is available in respect of gifts made by corporations to municipal or public bodies performing a function of government in Canada.

Paragraph 110.1(1)(*d*) is also amended to clarify its application to "real servitudes" under the Civil Code of Quebec.

The amendments to subsection 110.1(1) apply in respect of gifts made after December 20, 2002, except that the amendments to subparagraphs 110.1(1)(*a*)(iv.1) and 110.1(1)(*d*)(iii) apply in respect of gifts made after May 8, 2000.

## Gifts of Capital Property

ITA
110.1(2.1) and (3)

Subsection 110.1(3) of the Act provides that, if a corporation donates capital property to a charity, it may designate a value between the adjusted cost base and the fair market value of the donated property to be treated both as the proceeds of disposition for the purpose of calculating its capital gain and the amount of the gift for the purpose of the deduction allowed for charitable donations under subsection 110.1(1) of the Act.

Subsection 110.1(3) is restructured as new subsection 110.1(2.1) and revised subsection 110.1(3). New subsection 110.1(2.1) describes the circumstances under which amended subsection 110.1(3), which remains generally unchanged, will apply. However, where the property is depreciable property, subsection 110.1(2.1) includes those situations where the actual value of the gifted property is between the undepreciated capital cost of that class at the end of the taxation year of the corporation and the fair market value of the donated property.

Amended subsection 110.1(3) provides for the amount that may be designated by the corporation. As with the former provision, the amount designated is considered to be the corporation's proceeds of disposition of the gift. The subsection also continues to provide that the amount designated is treated as the fair market value of the property transferred by way of gift. However, under the amended version, this is for the purpose of new subsection 248(30) of the Act instead of for subsection 110.1(1). New subsection 248(30) generally provides that the "eligible amount" of a gift is the excess of the fair market value of a property transferred by way of gift over the value of the advantage or benefit, if any, to which the transferor is entitled. The "eligible amount" is relevant to the determination of the amount deductible under subsection 110.1(1) by the corporation.

Finally, amended subsection 110.1(3) allows a corporation to reduce the amount of recaptured depreciation that might otherwise be calculated in respect of a gift of depreciable property, with a corresponding reduction to the eligible amount deductible under subsection 110.1(1) in respect of the gift. However, the designated amount may not be lower than the amount of any actual proceeds of disposition in respect of the property (or, more specifically, the amount of the advantage in respect of the gift, as defined in new subsection 248(31) of the Act).

In particular, the amount designated by the corporation in respect of the property transferred may not exceed the fair market value of the property otherwise determined, and may not be less than the greater of

- the amount of the advantage, if any, in respect of the gift, and
- the adjusted cost base of the property or, if the property is depreciable property of the corporation, the undepreciated capital cost of the class of the property at the end of the corporation's taxation year (determined without reference to the proceeds of disposition designated in respect of the property).

See also the example in the commentary to subsections 118.1(5.4) and (6) of the Act, which apply similarly to individuals as do subsections 110.1(2.1) and (3) to corporations.

Subsections 110.1(2.1) and (3) of the Act (as amended) generally apply in respect of gifts made after 1999. For additional details regarding the eligible amount and the amount of the advantage in respect of a gift, see the commentary to new subsections 248(30) and (31) of the Act.

**Clause 48**

**Lifetime Capital Gains Exemption**

**Deduction Not Permitted**

ITA
110.6(7)

The French version of paragraph 110.6(7)(*b*) is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or her. This amendment will come into force on Royal Assent.

**Clause 50.1**

**Personal Tax Credits**

**Married Status**

ITA
118(1)(*a*)

Paragraph 118(1)(*a*) of the Act deals with the tax credit to persons who are married or in a common-law partnership. In 2000, the Act was amended to include common-law partners, but some provisions, including the English version of paragraph 118(1)(*a*), were overlooked. This paragraph is therefore amended to correct this omission. The amendment applies, in general, to the 2001 and subsequent taxation years. However, it may apply as of 1998 if the common-law partners jointly choose to be deemed as such, beginning in that year, for the purposes of the application of the Act.

**Pension Credit**

ITA
118(7)

**"pension income"**

Section 118 of the Act provides for a number of credits that are deductible in computing the tax payable by an individual, including the pension credit in subsection 118(3). The pension credit available to a taxpayer who is 65 years of age or older is based on the taxpayer's "pension income", as defined in subsection 118(7).

Pension income includes lifetime annuity payments under a pension plan and payments under a registered retirement income fund (RRIF).

The definition "pension income" is amended to add periodic payments under a money purchase provision of a registered pension plan (RPP), to the extent that such payments are not already included. This amendment is consequential on proposed amendments to the pension registration rules in the Regulations. The amendments allow money purchase RPPs to provide members with retirement benefits that are payable in the same manner as is permitted under a RRIF. Since these benefits would not be considered to be lifetime annuity payments, it is necessary to ensure that they qualify for the purpose of the pension credit. For more details, refer to the commentary on Regulation 8506 set out in Appendix A.

This amendment applies to the 2004 and subsequent taxation years.

**Clause 51**

**Charitable Donations Tax Credit**

ITA
118.1

Section 118.1 of the Act provides for a charitable donations tax credit to individuals in respect of gifts made to registered charities and to certain other entities. Section 118.1 is amended to expand the entities referred to in this section to include municipal or public bodies performing a function of government in Canada. This amendment is in response to the Quebec Court of Appeal decision in *Tawich Development Corporation* v. *Deputy Minister of Revenue of Quebec*, 2001 D.T.C. 5144. For additional information, see the commentary to paragraph 149(1)(*d*.5).

The amendments to section 118.1, described below, are made consequential to the addition of new subsections 248(30) to (38) of the Act. Generally, those subsections clarify the circumstances under which a transfer of property will be considered a gift notwithstanding that the donor may be entitled to receive an advantage or benefit in respect of the property. New subsection 248(30) generally provides that the "eligible amount" of the gift is the excess of the fair market value of a property transferred by way of gift over the value of the advantage or benefit, if any, to which the transferor is entitled. For additional information, see the commentary to new subsections 248(30) to (38).

**Definitions**

ITA
118.1(1)

Subsection 118.1(1) of the Act provides definitions of the terms "total charitable gifts", "total Crown gifts", "total cultural gifts" and "total ecological gifts". These definitions apply for the purpose of the tax credit available under subsection 118.1(3) of the Act to individuals who make such gifts. The amount of a gift that is eligible for a tax credit is, generally, the fair market value of the property disposed of by the individual in the making of the gift.

The definitions "total charitable gifts", "total Crown gifts", "total cultural gifts" and "total ecological gifts" in subsection 118.1(1) are amended, as a consequence of the addition of new subsection 248(30) of the Act, to provide that the amount that qualifies for the credit under subsection 118.1(3) is the "eligible amount" of a gift.

In addition, the definition of "total charitable gifts" and the definition of "total ecological gifts" in subsection 118.1(1) are expanded to include a gift to a municipal or public body performing a function of government in Canada.

The definition "total ecological gifts" is also amended to clarify its application to "real servitudes" under the Civil Code of Quebec.

Variable B in the formula the definition "total gifts" in subsection 118.1(1) generally provides that 100% of a taxable capital gain that results from a gift is included in the annual income limit that applies to gifts. This is an enhancement of the 75% income limit that generally applies to other types of income. Variable B is amended as a consequence of the addition of new subsection 248(30) of the Act, to ensure that the enhanced income limit only applies to the portion of a taxable capital gain that relates to the eligible amount of a gift.

The amendments to subsection 118.1(1) apply in respect of gifts made after December 20, 2002, except that the amendments to paragraph (*d*.1) of the definition of "total charitable gifts" and paragraph (*c*) of the definition of "total ecological gifts" apply in respect of gifts made after May 8, 2000.

**Gift of Capital Property**

ITA
118.1(5.4) and (6)

Subsection 118.1(6) of the Act provides that, if an individual donates capital property to a charity, the individual may designate a value between the adjusted cost base and the fair market value of the donated property to be treated both as the proceeds of disposition for the purpose of calculating the individual's capital gain and the amount of the gift for the purpose of calculating the tax credit allowed for charitable donations under subsection 118.1(3) of the Act.

Subsection 118.1(6) is restructured as new subsection 118.1(5.4) and revised subsection 118.1(6). New subsection 118.1(5.4) describes the circumstances under which amended subsection 118.1(6), which remain generally unchanged, will apply. However, where the property is depreciable property, subsection 118.1(5.4) includes those situations where the actual value of the gifted property is between the undepreciated capital cost of that class at the end of the taxation year of the individual and the fair market value of the donated property.

Amended subsection 118.1(6) provides for the amount that may be designated by the individual. As with the former provision, the amount designated is deemed to be the individual's proceeds of disposition of the gift. The provision also continues to provide that the amount designated is treated as the fair market value of the property transferred by way of gift. However, under the amended version, this is for the purpose of new subsection 248(30) of the Act (changed from subsection 118.1(1) of the Act). New subsection 248(30) generally provides that the "eligible amount" of the gift is the excess of the fair market value of a property transferred by way of gift over the value of the advantage or benefit, if any, to which the transferor is entitled. The "eligible amount" is relevant to the determination of the tax credit deductible by the individual under subsection 118.1(3).

Finally, amended subsection 118.1(6) effectively allows an individual to reduce the amount of recaptured depreciation that might otherwise be calculated in respect of a gift of depreciable property, with a corresponding reduction to the eligible amount deductible in respect of the gift under subsection 118.1(6). However, the designated amount may not be lower than the amount of any actual proceeds of disposition in respect of the property (or, more specifically, the amount of the advantage in respect of the gift, as defined under new subsection 248(31) of the Act).

In particular, the amount designated by the individual in respect of the property transferred may not exceed the fair market value of the property otherwise determined, and may not be less than the greater of

- the amount of the advantage, if any, in respect of the gift, and

- the adjusted cost base of the property or, if the property is depreciable property of the individual, the undepreciated capital cost of the class of the property at the end of the individual's taxation year (determined without reference to the proceeds of disposition designated in respect of the property).

Subsections 118.1(5.4) and (6) (as amended) generally apply in respect of gifts made after 1999. For additional details regarding the eligible amount and the amount of the advantage in respect of a gift, see the commentary to new subsections 248(30) and (31).

***Example***

*Mr. Adams transfers a rental property with a fair market value of $200,000 to a registered charity, in exchange for proceeds of disposition of $95,000. The original cost to Mr. Adams when he purchased the property in 1985 was $65,000. The rental property is the only depreciable property in its class, with an undepreciated capital cost balance before the transfer of $45,000.*

*Assuming that the transfer qualifies as a gift (see the commentary to subsections 248(30) to (32)), Mr. Adams may designate any amount between $95,000 and $200,000 as the proceeds of disposition for the gift. Mr. Adams could have designated an amount as low $45,000, if he had received a lesser amount in actual proceeds from the charity.*

*Mr. Adams decides to designate $150,000 as its proceeds of disposition. The taxable gain to Mr. Adams on the transfer can therefore be allocated as follows:*

| | | |
|---|---|---|
| *Designated proceeds* | | *$150,000* |
| *Adjusted cost base (original cost)* | *65,000* | *65,000* |
| *Capital Gain* | | *85,000* |
| *Taxable Capital Gain* | | *42,500* |
| *Undepreciated Capital Cost* | *45,000* | |
| *Recaptured depreciation* | | *20,000* |
| *Total Income Inclusion* | | *$ 62,500* |

*The eligible amount of the gift is calculated as follows:*

| | |
|---|---|
| *Designated proceeds* | *$150,000* |
| *Amount of advantage (consideration)* | *95,000* |
| *Eligible amount of the gift* | *55,000* |

**Clause 52**

**Medical Expense Tax Credit**

ITA
118.2(2)(*l*.1)

Paragraph 118.2(2)(*l*.1) of the Act allows for the deduction, as medical expenses, of certain expenses related to a bone marrow or organ transplant. The French version of the paragraph refers to "moelle épinière" rather than "moelle osseuse". The amendment corrects this error and will come into force on Royal Assent.

**Clause 59**

**Tax on Split Income**

ITA
120.4

Section 120.4 of the Act provides a special 29% tax applicable to certain passive income of individuals under the age of 18. These tax on split income rules were first proposed in the 1999 Budget Plan. At the time, the Government indicated that it "would monitor the effectiveness of this targeted measure, and may take appropriate action if new income-splitting techniques develop".

**Definitions**

ITA
120.4(1)

**"split income"**

The expression "split income" describes the type of income to which this measure applies.

Among other things, split income of an individual includes all amounts (other than excluded amounts) required to be included in the individual's income in respect of partnership or trust income if the

source of the income is the provision of goods or services by the partnership or trust to, or in support of, a business carried on by

- a person who is related to the individual,
- a corporation of which a person who is related to the individual is a specified shareholder, or
- a professional corporation of which a person related to the individual is a shareholder.

The phrase "goods or services" in the English version of subparagraph (*b*)(ii) and clause (*c*)(ii)(C) in the definition "split income" is replaced by the phrase "property of services". This ensures that the split income rules will apply to income from property, such as rental income. This change applies in computing the split income of a specified individual for taxation years that begin after December 20, 2002, other than in computing an amount included in that income that is from a trust or partnership for a fiscal period or taxation year of the trust or partnership that began before December 21, 2002. Also see the commentary to subsection 160(1.2) of the Act, which is amended consequential to this amendment.

**Clause 61**

**Small Business Deduction**

ITA
125(1)

Under subsection 125(1) of the Act, a CCPC's small business deduction for a taxation year is calculated as 16% of the least of three amounts. One of these, set out in paragraph 125(1)(*b*), is the amount by which the corporation's taxable income for the year exceeds income that has supported a foreign tax credit (FTC) or that is statutorily exempt from tax. The amount of income that has supported an FTC is determined by multiplying the corporation's FTCs for the year (subject to certain adjustments) by a factor that reflects an assumed rate of tax. For FTCs in respect of foreign non-business income, the factor is currently 10/3, reflecting an assumed tax rate of 30%. For business-income FTCs, the factor is currently 10/4, which reflects an assumed tax rate of 40%.

Subparagraph 125(1)(*b*)(ii) is amended to adjust the factor for foreign business income, as part of a series of amendments reflecting recent and planned reductions in income tax rates. The factor for business-income FTCs will become 3. This implies an assumed tax rate of

33.3%. This amendment applies to the 2003 and subsequent taxation years.

**Clause 62**

**Manufacturing and Processing Profits Deduction**

ITA
125.1(1)(*b*)(ii)

Subsection 125.1(1) of the Act provides the basic rules for the calculation of a corporation's manufacturing and processing profits deduction. The deduction for a given taxation year is the lesser of two amounts, one of which is the corporation's taxable income less certain other amounts. One of these other amounts, described in subparagraph 125.1(*b*)(ii), is the grossed up amount of the corporation's foreign tax credits (FTCs) for the year in respect of foreign businesses. Currently, the corporation's FTCs are grossed up by a factor of 10/4, which assumes this income was subject to tax at a rate of 40%.

Subparagraph 125.1(1)(*b*)(ii) is amended to adjust this factor to reflect recent reductions to income tax rates. The new factor will be 3, which implies an assumed tax rate of 33.3% on foreign source business income.

This amendment applies to the 2003 and subsequent taxation years.

**Clause 62.1**

**Resource Income**

**"taxable resource income"**

ITA
125.11

Section 125.11 of the Act has the effect of reducing the federal corporate income tax rate for income earned from resource activities from 28% to 21% by 2007. This is accomplished for the years 2003-2006 by providing a deduction against the 28% rate for income that falls within the definition of "taxable resource income". After 2006 resource income will be included in full rate taxable income and be subject to the general rate reduction rules.

Currently, a taxpayer's "taxable resource income" is the lesser of the taxpayer's taxable income for the taxation year and the amount calculated by the following formula: 3(A/B) + C- D. A represents the deduction taken as a resource allowance under paragraph 20(1)(*v*.1). B is a reduction of the resource allowance, which is being phased out between 2003 and 2006, prorated for non-calendar year-ends. C represents additions to the taxpayer's income resulting from negative resource pools. Lastly, D is any amounts deducted from income on account of resource pools.

The definition "taxable resource income" is being amended to ensure that resource income that was earned by a Canadian-controlled private corporation (CCPC) and received a small business deduction under section 125(1) of the Act is not also eligible for this rate reduction. The result is that a taxpayer's "taxable resource income" will now be the lesser of two amounts. The first amount is the taxpayer's taxable income for the year less 100/16 of the amount the taxpayer deducted from tax payable pursuant to section 125(1) of the Act. The second amount is calculated by the formula 3(A/B) + C - D - E. Elements A to D are unchanged from the previous formula contained in this definition, and remain as described above. New element E is 100/16 of the amount deducted from tax otherwise payable pursuant to subsection 125(1) of the Act. This amendment ensures that resource income earned by a CCPC can only benefit from one rate reduction.

This amendment applies to taxation years that begin after Announcement Date.

**Clause 63**

**Canadian Film or Video Production Tax Credit**

ITA
125.4

Section 125.4 of the Act sets out the rules that apply for the purpose of computing the Canadian film or video production tax credit ("CFVPTC"). Generally, this tax credit is available at a rate of 25% of qualified labour expenditures incurred by a qualified corporation for a production certified by the Minister of Canadian Heritage to be a Canadian film or video production.

Except as noted below, the amendments to subsection 125.4 generally apply in respect of productions for which development commences on or after November 14, 2003 or the first labour expenditures (as determined under subsections 125.4(1) and (2) as they applied before that date - the "old rules") of the production corporation are incurred

after 2003. As well, if development commenced before November 14, 2003 and the first labour expenditures (as defined under the old rules) were incurred by the corporation in its taxation year that includes November 14, 2003, the corporation may elect to have the new rules apply. Subject to this election, corporations must continue to claim the CFVPTC under the old rules for productions that qualified under those rules. Where, in the case of a co-production, more than one qualified corporation is eligible to claim a CFVPTC in respect of the production, the election to have the new rules apply must be made jointly. A production cannot qualify under both schemes.

**Definitions**

ITA
125.4(1)

**"assistance"**

In computing the CFVPTC, qualified labour expenditures in respect of a film or video production are limited to 48% of the amount by which the cost of the production exceeds any "assistance" in respect of that cost that has not been repaid.

The definition "assistance" is amended to provide that the equity share of a production of a government or other public authority is treated in the same manner as government assistance. This could include, for example, a loan from a government agency where repayment of the loan is dependent on profit from the production.

**"Canadian film or video production certificate"**

A qualified corporation must file a Canadian film or video production certificate with its tax return for a taxation year in which it claims a Canadian film or video production tax credit in respect of the production. A "Canadian film or video production certificate", as defined in subsection 125.4(1) of the Act, is issued by the Minister of Canadian Heritage. The definition is amended to provide that that Minister will also certify that the public funding of the production would not be contrary to public policy and that, generally, a qualified corporation or a related taxable Canadian corporation will retain an acceptable share of revenues from the exploitation of the production in non-Canadian markets. The Minister of Canadian Heritage will issue guidelines as to how these criteria can be met.

This amendment generally applies in respect of Canadian film or video productions for which certificates are issued by the Minister of Canadian Heritage after December 20, 2002.

The definition is also amended to remove the requirement for the Minister of Canadian Heritage to provide estimates relevant to the calculation of the CFVPTC, in respect of certificates issued after 2003.

**"investor"**

The definition "investor" describes a person who is not actively engaged on a regular, continuous, and substantial basis in a Canadian film or video production business carried on through a permanent establishment in Canada. A CFVPTC may not be claimed in respect of a Canadian film or video production where an investor, or a partnership in which an investor has an interest, may deduct an amount in respect of the production.

The definition of investor is repealed, applicable to taxation years that end after November 14, 2003, as well as to productions in respect of which a qualifying production corporation has, in a return of income filed before November 14, 2003, claimed an amount under subsection 125.4(3) of the Act in respect of a labour expenditure incurred after 1997 in respect of the production.

**"labour expenditure"**

The definition "labour expenditure" describes the underlying expenditures of a qualified corporation in respect of a film or video production that will be eligible for the CFVPTC. The definition is amended concurrently with the repeal of the definition "investor" in subsection 125.4(1) and the amendment of subsections 125.4(2) and (4) of the Act, to include those production expenditures incurred by the qualified corporation for or on behalf of another person. That is, labour expenditures are no longer limited to those included in the cost to the qualified corporation of the production. The definition is also amended concurrently with the introduction of the definition "production commencement time", which represents the time after which an eligible expenditure will qualify for the CFVPTC.

Where a particular corporation is a co-producer with another qualified corporation, and that other corporation has incurred expenditures for or on behalf of the taxpayer, new paragraph 125.4(2)(*d*) of the Act prevents the particular corporation from claiming a CFVPTC in respect of those expenditures.

For more information on subsections 125.4(2) and (4) and the definitions "investor" and "production commencement time", refer to the commentary for those provisions.

**"production commencement time"**

For the purpose of the definition "labour expenditure" in subsection 125.4(1) of the Act, in order to be eligible for the CFVPTC, expenditures in respect of a film or video production must be incurred by a qualified corporation from the time that is the "final script stage" of the production. The definition "labour expenditure" is amended to instead refer to expenditures incurred after the production commencement time. The new definition "production commencement time" describes the time that is the latest of the following:

1. The time at which a qualified corporation or its parent company first incurs development labour costs for the development of property of the corporation that is script material on which a Canadian film or video production is based.

2. The first time at which the qualified corporation or its parent company acquires a right in respect of the story that is the basis of the final script. Such rights might include a published literary work, play or screenplay.

3. Two years before the date on which principal photography of the production begins.

It is intended that the in-house development labour costs of an initial draft of a script, as well as the cost of modifications, should fall within the period of production for which labour expenditures qualify for the CFVPTC. These in-house costs could include the cost to hire an independent writer to create a script on the basis of some other story or literary work for which the rights have been acquired by the corporation.

Existing conditions on eligible labour expenditures also apply to scriptwriting labour. (See, for example, amounts excluded from the definition "salary and wages" in subsection 125.4(1) of the Act, such as amounts determined by reference to profits or revenues). As well, the cost to acquire an initial script or any other right referred to above will, like other rights, not qualify. Such an expenditure represents the cost of a property, not a labour expenditure.

The new definition "script material" in subsection 125.4(1) is defined for the purpose of the definition "production commencement time".

**"qualified labour expenditure"**

The definition "qualified labour expenditure" describes the portion of a qualified corporation's labour expenditures upon which it can claim a 25% investment tax credit for a Canadian film or video production. Under a formula in the definition, qualified labour expenditures in respect of a production are limited to 48% of the amount by which the cost of the production to the qualified corporation exceeds any "assistance" in respect of that cost that has not been repaid.

Variable A in the formula is amended to increase the maximum amount of labour expenditure that qualify for the CFVPTC from 48% to 60% of the cost of the production. The definition is also amended concurrently with the repeal of the definition "investor" in subsection 125.4(1) and the amendment of subsections 125.4(2) and (4) of the Act, to include in the production cost those production expenditures incurred by the qualified corporation for or on behalf of another person. That is, production expenditures are no longer limited to those included in the cost to the qualified corporation of the production.

Where the taxpayer corporation is a co-producer with another qualified corporation, and that other corporation has incurred expenditures for or on behalf of the taxpayer, those expenditures are excluded from the formula by new paragraph 125.4(2)(*b*) of the Act.

For more information on subsections 125.4(2) and (4) and the definition "investor", refer to the commentary for those provisions.

**"salary or wages"**

For the purposes of the Canadian film and video production tax credit, the definition "salary or wages", which is generally defined in subsection 248(1) of the Act, does not include an amount described in section 7 of the Act (share option benefits) or any amount determined by reference to profits or revenues.

The definition "salary or wages" is amended to provide that it also does not include an amount paid to a person in respect of services rendered by the person at a time when the person was non-resident, unless the person was at that time a Canadian citizen.

**"script material"**

The new definition "script material" applies for the purpose of determining the "production commencement time" of a production. Script material is written material describing the story on which the production is based and, for greater certainty, includes a draft script,

original story, screen story, narration, television production concept, outline or scene-by-scene schematic, synopsis or treatment. These descriptions are terms commonly used in the film production industry.

**Rules Governing Labour Expenditure of a Corporation**

ITA
125.4(2)

Subsection 125.4(2) of the Act provides rules that apply for the purpose of the definition of "labour expenditure" in subsection 125.4(1). Paragraph 125.4(2)(*a*) provides that remuneration does not include remuneration determined by reference to profits or revenues.

Subsection 125.4(2) is amended to provide that it also applies to the definition "qualified labour expenditure" in subsection 125.4(1). In addition, paragraph 125.4(2)(*a*) is amended to provide that remuneration also does not included remuneration in respect of services rendered by a person at a time when the person was non-resident, unless the person was at that time a Canadian citizen.

A film or video production may be produced jointly by two or more qualified corporations. New paragraph 125.4(2)(*d*) of the Act is added to ensure that only one qualified corporation may claim a CFVPTC in respect of any particular expenditure. Where another qualified corporation supplies goods to or renders services for or on behalf of the taxpayer corporation, new paragraph 125.4(2)(*d*) provides that the related expenditure by the taxpayer is not a labour expenditure, a cost or capital cost of the production to the taxpayer. This provision does not affect the calculation of the cost of the production for other purposes of the Act.

**Exception**

ITA
125.4(4)

Subsection 125.4(4) of the Act provides that a Canadian film or video production tax credit is not available for a production if an investor may deduct an amount in respect of the production in computing its income for any taxation year. An investor is defined in subsection 125.4(1) to include, generally, any person, other than a prescribed person, that does not carry on a film or video production basis in Canada on a substantial basis.

Subsection 125.4(4) is amended concurrently with the repeal of the definition "investor", to deny the CFVPTC only in circumstances where the production or a person or partnership holding an interest in

the production is a tax shelter investment for the purpose of section 143.2 of the Act.

However, proposed *Income Tax Regulations* include a requirement that, for a film or video production to qualify as a Canadian film or video production eligible for the CFVPTC, a prescribed taxable Canadian corporation must retain worldwide ownership of copyright.

This amendment applies to taxation years that end after November 14, 2003, or if a qualifying production corporation has, in a return of income filed before November 14, 2003, claimed an amount under subsection 125.4(3) in respect of a labour expenditure incurred after 1997 in respect of the production.

**Revocation of a Certificate**

ITA
125.4(6)

Subsection 125.4(6) of the Act provides that a Canadian film or video production certificate in respect of a production may be revoked by the Minister of Canadian Heritage. The revocation of a certificate may occur if an incorrect statement or an omission was made in order to obtain the certificate, or if the production is not a Canadian film or video production. A revoked certificate is considered never to have been issued, so a Canadian film or video production tax credit under new subsection 125.4(3) cannot be claimed in respect of the decertified production.

Subsection 125.4(6) is amended, applicable after November 14, 2003, to clarify that a Canadian film or video production certificate may be revoked in respect of one episode of a television series without affecting the eligibility of other episodes in the series and that, in such a case, the expenditures attributable to that episode do not qualify for the CFVPTC.

**Guidelines**

ITA
125.4(7)

New subsection 125.4(7) of the Act, which applies in respect of Canadian film or video productions for which certificates are issued by the Minister of Canadian Heritage after December 20, 2002, requires the Minister of Canadian Heritage to issue guidelines respecting the circumstances under which new conditions in the definition "Canadian film or video production certificate" in

subsection 125.4(1) are met. For further details, see the commentary for that definition.

## Clause 64

### Foreign Tax Credit

### Former Resident - Trust Beneficiary

ITA
126(2.22)

The French version of subsection 126(2.22) of the Act is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or her. These amendments will come into force on Royal Assent.

### Rules of Construction

ITA
126(6)(*d*)

Section 126 of the Act permits a taxpayer to claim a foreign tax credit. Subsection 126(1) sets out the rules for claiming the credit in respect of foreign non-business-income tax - that is, the foreign taxes imposed on investment income and other categories of foreign source non-business income. A credit in respect of foreign taxes on business income is provided under subsection 126(2).

Subsection 126(1) has been interpreted to allow a non-business foreign tax credit for non-business foreign tax paid on interest income earned abroad by a Canadian business that does not carry on business in the foreign jurisdiction, and therefore is not eligible for a business foreign tax credit. In order to ensure that the credit continues to be available in these situations, subsection 126(6), which contains interpretation rules that apply to the section, is amended to add new paragraph 126(6)(*d*). New paragraph 126(6)(*d*) deems foreign interest income earned from a business carried on in Canada, and for which the business has paid a non-business foreign tax to a country other than Canada, to be from a source in that other country. Therefore, if a taxpayer includes in its Canadian business income for the year foreign interest income, and has paid foreign tax with respect to this amount, the taxpayer will eligible to claim a non-business foreign tax credit subject to the limits set out in section 126.

New paragraph 126(6)(*d*) applies to amounts received after Announcement Date.

## Clause 66

### Deductions in Computing Tax

### Logging Tax Deduction

ITA
127(2)

The amendments to the French version of subsection 172(2) of the Act correct a grammatical error. In this subsection, the expression “revenu tiré pour l’année des opérations forestières dans la province” has the meaning set out in the Income Tax Regulations. However, the expression that appears in the Regulations is “revenu tiré pour l’année d’opérations forestières dans la province”, which is grammatically correct. The Act is therefore amended accordingly on Royal Assent.

### Contributions to Registered Parties and Candidates

ITA
127(3)

Subsection 127(3) of the Act provides a tax credit to a taxpayer in respect of amounts contributed to a registered party or to a candidate. Subsection 127(3) is amended consequential to the addition of new subsections 248(30) and (31) of the Act, to provide that the amount of a contribution that is eligible for the political contributions tax credit is to be reduced by the amount of any advantage or benefit, as defined by subsection 248(31), to which the taxpayer is entitled in respect of the contribution.

It is proposed that subsections 2000(1) and (6) of the Regulations be amended to provide that every official receipt issued by a registered party in respect of a contribution contain, in addition to the information already prescribed, a the eligible amount and the amount of the advantage, if any, in respect of the contribution.

For additional details, see the commentary to new subsections 248(30) and (31) regarding the amount of the advantage in respect of a contribution.

## Clause 67

### Labour-Sponsored Venture Capital Corporations

### Definitions

ITA
127.4(1)

**"approved share"**

Subsection 127.4(2) of the Act allows an individual (other than a trust) a tax credit for the acquisition of an "approved share", which is defined in subsection 127.4(1) as, generally, a share issued by a prescribed LSVCC. LSVCCs prescribed for this purpose under section 6701 of the Regulations include LSVCCs registered under Part X.3 of the Act, as well as specified provincially registered LSVCCs. Paragraph (*b*) of the definition "approved share" excludes from the definition certain shares issued by a provincially-registered LSVCC that is not a federally-registered LSVCC. This exclusion applies only in the event that, at the time of the issue of the shares, no assistance is available in respect of the acquisition of such shares because of a suspension or termination of assistance to the LSVCC under the laws of every province in which the LSVCC is registered.

Paragraph (*b*) of the definition "approved share" is amended to provide that an approved share does not include a share issued by a provincially-registered LSVCC (that is not a federally-registered LSVCC) if, at the time of the issue, no province under the laws of which the corporation is an LSVCC that is a prescribed LSVCC provides assistance in respect of the acquisition of the share. This amendment is provided to have the definition "approved share" better reflect the policy that a federal income tax credit be available in respect of a share issued by a provincially-registered LSVCC (that is not a federally-registered LSVCC) only if a provincial income tax credit is also available in respect of the share.

Paragraph (*b*) of the definition will continue to apply if, at the time of the issue by such an LSVCC of a share, no assistance is available in respect of the acquisition of shares of the LSVCC because of a suspension or termination of assistance to the LSVCC under the laws of every province in which the LSVCC is registered.

Amended paragraph (*b*) of the definition will also apply where there has not been a suspension or termination of assistance with respect to the issuance of the LSVCC's shares generally, but assistance is not available with respect to the acquisition of a particular share. For example, if under the laws of a province under which an LSVCC is a

prescribed LSVCC, a taxpayer who acquires a share is not entitled to any assistance in respect of the acquisition either because of having reached the age of 65 years or because of the province of residence of the taxpayer, the share will not be treated as an approved share.

This amendment applies to the 2003 and subsequent taxation years.

**"qualifying trust"**

Subsection 127.4(1) of the Act contains the definition of "qualifying trust". In 2000, the Act was amended to include common-law partners, but some provisions, including the English version of the definition of "qualifying trust", were overlooked. This definition is therefore amended to correct this omission. The amendment applies, in general, to the 2001 and subsequent taxation years. However, it may apply as of 1998 if the common-law partners jointly choose to be deemed as such, beginning in that year, for the purposes of the application of the Act.

## Clause 69.1

### Returning Trust Beneficiary

ITA
128.1(7)

The French version of subsection 128(7) of the Act is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or her. This amendment will come into force on Royal Assent.

## Clause 70

### Private Corporations - "refundable dividend tax on hand"

ITA
129(3)(*a*)

Section 129 of the Act allows a private corporation that pays a taxable dividend to obtain a partial refund of the income taxes it has paid on its investment income. For this purpose, paragraph 129(3)(*a*) adds to the refundable dividend tax on hand of a Canadian-controlled private corporation at the end of a taxation year the least of three amounts.

One of these amounts, which is described in subparagraph 129(3)(*a*)(ii), is 26 2/3% of a corporation's taxable income, less income that either benefited from the section 125 small business deduction or supported a foreign tax credit (FTC). Income that supported an FTC is measured by multiplying both the corporation's non-business- and its business-income FTCs by factors that reflect assumed Canadian tax rates. Subparagraph 129(3)(*a*)(ii) is amended to adjust the factor for foreign business income. The factor for business-income FTCs will become 3. This implies an assumed tax rate of 33.3%.

This amendment applies to the 2003 and subsequent taxation years.

**Clause 70.1**

**Definition "mutual fund trust"**

ITA
132(6)(*c*)

Subsection 132(6) of the Act sets out the definition "mutual fund trust". Under paragraph 132(6)(*c*), a trust will qualify at any time as a mutual fund trust only if at that time it meets prescribed conditions relating to the number of its unit holders, dispersal of ownership of trust units issued by it and public trading of trust units issued by it.

Paragraph 132(6)(*c*) is amended so that the prescribed conditions that a trust may be required to satisfy in order to qualify as a mutual fund trust are not limited to those relating to ownership and trading of its units.

This amendment applies to the 2000 and subsequent taxation years.

**Clause 72**

**Mutual Fund Qualifying Exchanges**

**Definition "designated beneficiary"**

ITA
132.2(3)(*g*)(iii) and 132.2(1)(*j*)(iii)

New subparagraph 132.2(3)(*g*)(iii) of the Act applies in determining whether a person is a "designated beneficiary" (as defined in section 210 of the Act) of a trust. Under the definition designated beneficiary, certain persons or partnerships that are beneficiaries

under a trust may be treated (or may cause trusts or partnerships of which they are beneficiaries or members to be treated) as designated beneficiaries under the trust, unless the relevant interest in the trust is held at all times by the person or partnership, as the case may be, or by another person exempt because of subsection 149(1) of the Act from tax, under Part I of the Act, on all of the other person's taxable income.

In a qualifying exchange, a mutual fund trust or mutual fund corporation (transferor) transfers all or substantially all of its property to another mutual fund trust (transferee) and takes back units of the transferee. Those units are then provided by the transferor to its investors in exchange for their shares or units of the transferor. New subparagraph 132.2(3)(*g*)(iii) ensures that, in these circumstances, the transferor is treated, for the purpose of the definition designated beneficiary, as not having held the units of the transferee.

This amendment applies for qualifying exchanges that occur after 1998. A similar rule, in former subparagraph 132.2(1)(*j*)(iii), applies for qualifying exchanges that occurred after June 1994 and before 1999.

## Clause 73

### Non-resident-owned Investment Corporations - Transition

ITA
134.1(2)

Section 134.1 of the Act was enacted, along with section 134.2, in 2001 to provide transitional relief for corporations that cease to be non-resident owned investment corporations (NROs). The essence of the relief provided in section 134.1 is to allow such a corporation to recover refundable tax by paying a dividend in its "first non-NRO year". In its current form, the section applies only in respect of dividends paid to a non-resident person or another NRO. There is, however, another kind of shareholder to whom an NRO may pay a dividend in respect of which it is appropriate to apply the section - a trust for the benefit of non-resident persons or their unborn issue. Since such a trust could, under the rules that have governed NROs themselves, have held the shares and debt of an NRO, a dividend to the trust ought to support a refund of the former NRO's refundable tax. Subsection 134.1(2) is therefore amended to include such dividends within the section's scope.

In addition, subsections 104(10) and (11) of the Act are added to the list of provisions in subsection 134.1(2) for which a former NRO is

deemed to be an NRO during its first non-NRO year. Prior to the repeal of the NRO system, a trust that received a dividend from an NRO and that did not in turn distribute the amount of the dividend to its non-resident beneficiaries was entitled to deduct that amount from the trust's income under subsection 104(10). Subsection 104(11) then deemed the amount deducted under subsection 104(10) to have been paid to a non-resident beneficiary, with the result that Part XIII withholding tax would typically be payable. These two subsections are included in subsection 134.1(2) in order to allow a trust to benefit from these provisions in the year it receives the final payment of dividends from the former NRO.

Both of these amendments apply on the same basis as section 134.1: that is, to a corporation that ceases to be an NRO because of a transaction or event that occurs, or a circumstance that arises, in a taxation year of the corporation that ends after February 27, 2000.

**Clause 77**

**Insurance Corporations**

**Insurer's Income or Loss**

ITA
138(2)

Subsection 138(2) of the Act provides rules relating to the calculation of the income of a resident life insurer that carries on an insurance business in Canada and in a country outside Canada in a taxation year.

Paragraph 138(2)(*a*) provides that the resident life insurer's income or loss for a taxation year from an insurance business carried on both inside and outside Canada by the insurer is the insurer's income or loss for the year from carrying on that insurance business in Canada. Resident life insurers are, therefore, not subject to Canadian tax on their foreign insurance business income.

Paragraph 138(2)(*b*) provides that taxable capital gains and allowable capital losses from dispositions of property that are not designated insurance property are not included in computing the resident life insurer's income where the property is used or held in the course of carrying on its insurance business.

The expression "designated insurance property" is defined in subsection 138(12) of the Act and in section 2401 of the Regulations.

Subsection 138(2) of the Act is amended in the following ways.

New paragraph (*a*) ensures that the gross investment revenue from property of a resident life insurer (used or held by it in the course of carrying on an insurance business) will be included in computing the insurer's income from its insurance business in Canada only where the property is a designated insurance property of the insurer for the year.

It also ensures that taxable capital gains and allowable losses from dispositions of the insurer's property used or held by the insurer in the course of carrying on an insurance business will be included in computing the insurer's income for a taxation year from its insurance business in Canada only where the property disposed of was designated insurance property for the taxation year in which the insurer disposed of the property.

New paragraph (*b*) ensures that the gross investment revenue from property of a non-resident insurer that carries on an insurance business in Canada (used or held by it in the course of carrying on an insurance business) will be included in computing the insurer's income from its insurance business in Canada only where the property is a designated insurance property of the insurer for the year.

It also ensures that taxable capital gains and allowable losses from dispositions of the insurer's property used or held by the insurer in the course of carrying on an insurance business will be included in computing the insurer's income for a taxation year from its insurance business in Canada only where the property disposed of was designated insurance property for the taxation year in which the insurer disposed of the property.

The definition "designated insurance property" in subsection 248(1) of the Act adopts the definition in subsection 138(12).

These amendments to subsection 138(2) apply to taxation years that end after 1999.

## Clause 78

### Mark-to-Market Rules

ITA
142.6(1)

Subsection 142.6(1) of the Act contains rules that apply where a taxpayer becomes (or ceases to be) a financial institution. This is most likely to happen where the change of status occurs because the taxpayer becomes (or ceases to be) controlled by a financial institution.

If a taxation year of the taxpayer does not end immediately before the time at which its status as a financial institution changes, subparagraph 142.6(1)(*a*)(i) deems the taxpayer's taxation year that would otherwise have included that time to end immediately before that time. A new taxation year begins at that time, and the taxpayer is permitted to adopt a new fiscal period. One purpose for the deemed year-end is to ensure the proper application, in taxation years in which the taxpayer is a financial institution, of the rules, commonly known as the mark-to-market rules,

- in section 142.3 of the Act for specified debt obligations, and

- in section 142.5 of the Act for market-to-market properties.

The expressions "financial institution", "specified debt obligation" and "mark-to-market property" are defined in section 142.2 of the Act.

Paragraph 142.6(1)(*b*) applies where a taxpayer becomes a financial institution. This paragraph generally provides for a deemed disposition at fair market value of each property held by the taxpayer that is

- a specified debt obligation (other than a specified debt obligation that is a mark-to-market property to which subparagraph 142.6(1)(*b*)(ii) applies)[1], or

- a mark-to-market property for the taxpayer's taxation year that ends immediately before the time of the change of status[2].

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[1] Subparagraph 142.6(1)(*b*)(i)

[2] Subparagraph 142.6(1)(*b*)(ii)

This deemed disposition under paragraph 142.6(1)(*b*) is intended to ensure that amounts brought, because of the mark-to-market rules in sections 142.3 and 142.5, into the taxpayer's income for the taxpayer's subsequent taxation year (i.e., the taxation year that includes the time of the change of status) do not include gains or losses accrued before the beginning of that subsequent taxation year.

Paragraph 142.6(1)(*b*) is amended to ensure that this is achieved in connection with mark-to-market properties. Amended paragraph 142.6(1)(*b*) results in the taxpayer being deemed to have disposed of, immediately before the end of its particular taxation year that ends immediately before the time of the change of status, and for proceeds equal to its fair market value at the time of that disposition, a mark-to-market property of the taxpayer

- for the particular taxation year, or

- for the subsequent taxation year.

Paragraph 142.6(1)(*c*) provides for a deemed disposition of specified debt obligations (other than mark-to-market property) in the opposite situation of change of status, i.e., where the taxpayer ceases to be a financial institution. Paragraph 142.6(1)(*d*) provides that the taxpayer is deemed to have reacquired, at the end of the taxation year referred to in paragraph 142.6(1)(*b*) or (*c*), each property deemed by that paragraph to have been disposed of by the taxpayer, at a cost equal to the proceeds of disposition of the property.

Consequential to the amendments to paragraph 142.6(1)(*b*), paragraph 142.6(1)(*d*) is amended to provide that the taxpayer is deemed to have reacquired, at the end of its taxation year that ends immediately before the time of the change of status, each property deemed by paragraph 142.6(1)(*b*) or (*c*) to have been disposed of by the taxpayer, at a cost equal to the proceeds of disposition of the property.

Amended paragraphs 142.6(1)(*b*) and (*d*) apply to taxation years that end after 1998.

**Clause 80.1**

**Limited-recourse Debt in Respect of a Gift or Monetary Contribution**

ITA
143.2(6.1)

New subsection 143.2(6.1) of the Act describes limited-recourse debt in respect of a gift or monetary contribution made after February 18, 2003. Such an amount is an advantage under subsection 248(31) of the Act, such that it reduces the eligible amount of a gift or political contribution determined under subsection 248(30) of the Act. For additional details regarding the amount of an advantage, see the commentary to new subsection 248(31).

A limited-recourse debt includes the unpaid principal of any indebtedness for which recourse is limited, even if that limitation applies only in the future or contingently. It also includes any other indebtedness of the taxpayer, related to the gift or contribution, if there is a guarantee, security or similar indemnity or covenant in respect of that or any other indebtedness. For example, if a donor (or any other person mentioned below) enters into a contract of insurance whereby all or part of a debt will be paid upon the occurrence of either a certain or contingent event, the debt is a limited-recourse debt in respect of a gift if it is in any way related to the gift.

Such an indebtedness is also a limited-recourse debt if it is owed by a person dealing non-arm's length with the taxpayer or by a person who holds an interest in the taxpayer.

**Information Located Outside Canada**

ITA
143.2(13)

Subsection 143.2(13) of the Act applies where information related to an indebtedness in respect of an expenditure is located outside Canada, and the Minister of National Revenue is not satisfied that the indebtedness is not a limited-recourse amount. In such a case, the indebtedness is deemed to be a limited-recourse amount in respect of the expenditure. Subsection 143.2(13) is extended to also apply in respect of an indebtedness that relates to a gift or political contribution made after February 18, 2003.

**Clause 83**

**Registered Education Savings Plans - Conditions for Registration**

ITA
146.1(2)(*g*.3) and (2.3)

Subsection 146.1(2) of the Act sets out the conditions that must be satisfied in order for an education savings plan to be accepted for registration.

New paragraph 146.1(2)(*g*.3) is introduced to preclude non-residents and individuals who have not yet been assigned a Social Insurance Number (SIN) from becoming a beneficiary under a registered education savings plan (RESP) or from benefiting from RESP contributions.

Specifically, paragraph 146.1(2)(*g*.3) requires that an education savings plan not permit an individual to be designated as a beneficiary under the plan and not allow a contribution for a beneficiary under the plan, unless the individual's SIN has been provided to the promoter of the plan and the individual is resident in Canada.

If an individual is designated as a beneficiary under an RESP in conjunction with the transfer of property into the plan from another RESP under which the individual was a beneficiary immediately before the transfer, the requirement that the individual be resident in Canada in order to be designated as a beneficiary does not apply. However, subject to the exceptions in new subsection 146.1(2.3), the individual's SIN has to be provided to the promoter in order for the individual to be designated as a beneficiary under the transferee RESP. This special rule is intended primarily to accommodate transfers from an RESP to a replacement RESP after the beneficiary has ceased to be resident of Canada. (It should be noted that the transfer itself, as a contribution to an RESP, is not subject to the SIN and residency conditions that apply to ordinary contributions.)

New subsection 146.1(2.3) provides two additional exceptions to the SIN condition that are primarily of relevance to RESPs that were entered into before 1999 and RESPs that replace such plans. These exceptions recognize that the Canada Customs and Revenue Agency only began requiring the beneficiary's SIN to be provided on the application for registration for plans entered into after 1998.

The first new exception allows an education savings plan that was entered into before 1999 to not require that an individual's SIN be provided in respect of a contribution to the plan. Such contributions,

however, continue to be ineligible for the Canada Education Savings Grant. It should be noted that this exception is only relevant for contributions made for existing beneficiaries under such plans. An individual without a SIN is prevented from being designated as a new beneficiary under such a plan.

Under the second new exception, an education savings plan may permit a non-resident individual who does not have a SIN to be designated as a beneficiary under the plan provided that the designation is being made in conjunction with a transfer of property into the plan from another RESP under which the individual was a beneficiary immediately before the transfer. This exception is intended, in particular, to accommodate the transfer of property from an RESP that was entered into before 1999, under which the beneficiary had always been non-resident or had ceased to be resident in Canada before having been assigned a SIN, to a replacement RESP (and successive transfers).

Paragraph 146.1(2)(*g*.3) and subsection 146.1(2.3) apply after 2003.

**Clause 84**

**Registered Retirement Income Funds**

**Amount Included in Income**

ITA
146.3(5.1)

In 2000, the Act was amended to include common-law partners, but some provisions, including the English version of subsection 146.3(5.1), were overlooked. This subsection is therefore amended to correct this omission. The amendment applies, in general, to the 2001 and subsequent taxation years. However, it may apply as of 1998 if the common-law partners jointly choose to be deemed as such, beginning in that year, for the purposes of the application of the Act.

**Clause 87**

**Exemptions - Municipalities and Other Governmental Public Bodies**

ITA
149(1)(*d*.5)

Paragraph 149(1)(*d*.5) of the Act exempts from tax, subject to an income test, the taxable income of any corporation, commission or association at least 90% of the capital of which is owned by one or more municipalities in Canada.

In accordance with the Tax Court of Canada decision in *Otineka Development Corporation Limited and 72902 Manitoba Limited* v. *The Queen*, 94 D.T.C. 1234, [1994] 1 C.T.C. 2424, an entity could be considered a municipality for the purpose of this paragraph on the basis of the functions it exercised. More recently, however, the decision in *Tawich Development Corporation* v. *Deputy Minister of Revenue of Quebec*, [1997] 2 C.N.L.R. 187 (Que. Civil Chamber), aff'd 2001 D.T.C. 5144 (Que. C.A.), a decision under the *Taxation Act* (Quebec), held that an entity could not attain the status of a municipality by exercising municipal functions but only by statute, letters patent or order. From a tax policy perspective, it is desired that the entities previously entitled to the exemption on the basis of the *Otineka* decision continue to have access to the exemption. This amendment resolves the uncertainty resulting from the two conflicting cases. The exemption in paragraph 149(1)(*d*.5) is therefore extended to include any corporation, commission or association at least 90% of the capital of which was owned by one or more entities each of which is a municipal or public body performing a function of government in Canada, which is consistent with the bodies described in paragraph 149(1)(*c*) of the Act.

This amendment applies to taxation years that begin after May 8, 2000.

**Exemptions - Subsidiaries of Municipal Corporations**

ITA
149(1)(*d*.6)

Paragraph 149(1)(*d*.6) of the Act exempts from tax, subject to an income test, a wholly-owned subsidiary of a corporation, commission or association referred to in paragraph 149(1)(*d*.5) of the Act. As a consequence of the amendment to paragraph 149(1)(*d*.5), the geographical boundaries of the entities referred to in subparagraphs (i)

and (ii) of paragraph 149(1)(*d*.6) are expanded to include references to all of the entities in the amended 149(1)(*d*.5).

This amendment applies to taxation years that begin after May 8, 2000.

**Income Test**

ITA
149(1.2)

Subsection 149(1.2) of the Act excludes, for the purposes of paragraphs 149(1)(*d*.5) and (*d*.6) of the Act, certain income from the determination of where an entity to which either of those paragraphs applies derives its income. As a consequence of the amendment to paragraph 149(1)(*d*.5), a written agreement in subsection 149(1.2) is expanded to include reference to a municipal or public body.

In addition, subparagraph 149(1.2)(*a*)(vi) is added to clarify that the geographical boundary of a municipal or public body performing a function of government in Canada is defined to be the area described in new subsection (11).

This amendment applies to taxation years that begin after May 8, 2000.

**Votes or de Facto Control**

ITA
149(1.3)

Subsection 149(1.3) of the Act provides that, for the purposes of applying paragraph 149(1)(*d*.5) and subsection 149(1.2) of the Act to a corporation, 90% of the capital of the corporation is considered to be owned by one or more municipalities only if the municipalities are entitled to at least 90% of the votes associated with the shares of the corporation.

As a consequence of the amendment to paragraph 149(1)(*d*.5), subsection 149(1.3) is amended applicable to taxation years that begin after May 8, 2000, to include reference to municipal or public bodies performing a function of government in Canada.
In addition, subsection 149(1.3) is replaced, applicable to taxation years that begin after December 20, 2002, to provide that paragraphs 149(1)(*d*) to (*d*.6) do not apply to exempt a person's taxable income for a period in a taxation year in two cases.

First, under new paragraph 149(1.3)(*a*), a corporation is not exempt from tax on its taxable income for a period in a taxation year if at any time during the period the corporation has issued shares that are owned by one or more persons (other than certain tax-exempts) that, in total, give them more than 10% of the votes that could be cast at a meeting of shareholders. For this purpose, it is necessary to determine whether more than 10% of the votes could be cast at a meeting of the shareholders by a person or persons other than:

- Her Majesty in right of Canada or of a province,
- a municipality in Canada,
- a municipal or public body performing a function of government in Canada, or
- a commission, an association or a corporation, to which any of paragraphs 149(1)(*d*) to (*d*.6) apply.

Second, under new paragraph 149(1.3)(*b*), a person is not exempt because of any of paragraphs 149(1)(*d*) to (*d*.6) from tax on taxable income for a period in a taxation year if at any time in the period the person is, or would be if the person were a corporation, controlled, directly or indirectly in any manner whatever, by a person (or by a group of persons that includes a person) other than:

- Her Majesty in right of Canada or of a province,
- a municipality in Canada,
- a municipal or public body performing a function of government in Canada, or
- a commission, an association or a corporation, to which any of paragraphs 149(1)(*d*) to (*d*.6) apply.

For further details about the expression "controlled, directly or indirectly in any manner whatever", reference should be made to subsections 256(5.1) and (6) of the Act. In general, the expression refers to a controller, who has any direct or indirect influence that, if exercised, would result in control in fact of the person.

**Geographical Boundaries - Body Performing Government Functions**

ITA
149(11)

Subsection 149(11) of the Act is added to define, for the purposes of section 149, the geographical boundaries of a municipal or public body performing a function of government in Canada. Those boundaries are defined as encompassing the area in respect of which an Act of Parliament or an agreement given effect by an Act of Parliament recognizes or grants to the body a power to impose taxes;

or if there has been no such recognition or grant, the area within which the body has been authorized by the laws of Canada or of a province to exercise that function.

For example, if a particular self-governing First Nation meets the definition of "a public body performing a function of government in Canada," it is intended that the relevant geographic boundary would delineate the area where the self-government agreement, or the statute enacting self-government powers, provides the First Nation authority to impose direct taxes. As a second example, if a particular Indian Band meets the definition of "a public body performing a function of government in Canada," it is intended that the geographic boundary of the Indian Band be the band's reserves as defined in the *Indian Act*. Similarly, if a particular school board meets the definition of "a municipal or public body performing a function of government in Canada" it is intended that the geographic boundary of the school board be the area of jurisdiction of the board as defined by provincial legislation or regulation.

This amendment applies to taxation years that begin after May 8, 2000.

## Clause 88

### Charities

### Revocation of Registration

ITA
149.1(2), (3) and (4)

Subsections 149.1(2), (3) and (4) of the Act set out the reasons for which the Minister of National Revenue may revoke the registration of a charitable organization, a public foundation and a private foundation, respectively. These subsections are amended to permit the revocation of the registration of such entities if they make gifts (other than gifts made in the course of their charitable activities) to persons or entities that are not qualified donees. A "qualified donee" is essentially a person or entity to which a tax deductible or tax creditable donation may be made.

These amendments apply to gifts made after December 20, 2002.

**Clause 107.1**

**Distribution Deemed Disposition**

ITA
200

The French version of section 200 of the Act is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or her. This amendment will come into force on Royal Assent.

**Clause 108.1**

**Transfers Between Plans**

ITA
204.9(5)

The French version of section 200 of the Act is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or her. This amendment will come into force on Royal Assent.

**Clause 109**

**Tax in Respect of Certain Property Acquired by Trusts, etc.**

ITA
Part XI

Part XI of the Act sets out rules for the 1% per month penalty tax on registered pension plans, registered retirement savings plans and other deferred income plans and funds in respect of their excess foreign property holdings.

**Definitions**

ITA
206(1)

**"foreign property"**

"Foreign property" is defined in subsection 206(1) of the Act. Under paragraph (*d*.1) of the definition, foreign property includes certain shares and debt issued by Canadian corporations, if shares of the corporation may reasonably be considered to derive their value primarily from foreign property. Paragraph (*g*) of the definition treats as foreign property the indebtedness of a non-resident person other than indebtedness issued by various international organizations or indebtedness issued by an authorized foreign bank and payable at a Canadian branch of that bank.

Paragraphs (*d*.1) and (*g*) are amended to provide that an indebtedness that is a mortgage obligation secured by real property situated in Canada is not foreign property. For the exclusion to apply, the amount of the mortgage obligation (together with the amount of any other indebtedness in respect of the property that is of equal or superior rank) must not exceed the fair market value of the property, except as a result of a decline in the fair market value of the real property after issuance of the mortgage obligation. This test applies on an on-going basis. These amendments apply to months ending after October 2003.

**Clause 110**

**Definitions and Application**

ITA
210

Section 210 of the Act defines "designated beneficiary" for the purpose of Part XII.2.

Section 210 is amended so that a number of definitions that apply for the purposes of Part XII.2 are now found in new subsection 210(1). In addition, new subsection 210(2) replaces section 210.1 of the Act, which is being repealed.

**Definitions**

ITA
210(1)

New subsection 210(1) of the Act contains the definitions "designated beneficiary" (previously found in section 210 of the Act) and "designated income" (previously found in subsection 210.2(2) of the Act). These definitions apply in Part XII.2.

**"designated beneficiary"**

Under paragraphs (*a*) and (*b*) of the definition "designated beneficiary", a designated beneficiary includes, respectively, a non-resident person and a non-resident-owned investment corporation. Under paragraph (*c*) of the definition, a person exempt from tax under Part I of the Act is treated as a designated beneficiary because of owning an interest in a trust (acquired from a beneficiary under the trust) unless, generally speaking, no taxable entity previously owned that interest. Under paragraph (*d*) of the definition, a trust is a designated beneficiary of another trust if a beneficiary of the trust includes, generally, either a person or partnership described in any of paragraphs (*a*), (*b*), (*c*) or (*e*) of the definition or another trust (other than a testamentary trust resident in Canada). Under paragraph (*e*) of the definition, a partnership is a designated beneficiary of a trust if a member of the partnership is a person described in paragraph (*a*), (*b*) or (*d*) of the definition, another partnership or a person exempt from tax under Part I by reason of subsection 149(1) of the Act.

The opening words of the definition "designated beneficiary" are amended so that the references in the definition to a "trust" under which there may be a designated beneficiary are references to a "particular trust".

Paragraph (*c*) of the definition "designated beneficiary" is amended to clarify that a designated beneficiary of a particular trust includes, except as provided in subparagraphs (*c*)(i) and (ii) of the definition, a person who is, because of subsection 149(1), exempt from tax under Part I on all or part of their taxable income and who acquired an interest in the particular trust after October 1, 1987 directly or indirectly from a beneficiary under the particular trust.

Paragraph (*d*) of the definition "designated beneficiary" is amended so that a designated beneficiary of a particular trust includes another trust (in this commentary referred to as the "other trust") having as a beneficiary any one of the following persons or partnerships:

- under subparagraphs (*d*)(i) and (ii) of the definition, a non-resident person (including a trust) or a non-resident-owned investment corporation;

- under subparagraphs (*d*)(iii) of the definition, any trust, other than

  - a testamentary trust (however, note that if the testamentary trust were non-resident, the other trust would be treated as a designated beneficiary of the particular trust because of subparagraph (*d*)(i)),

  - a mutual fund trust,

  - a trust that is exempt because of subsection 149(1) from tax under Part I on all or part of its taxable income (however, note that under subparagraph (*d*)(iv), described below, such a trust may cause the other trust to be a designated beneficiary of the particular trust), and

  - a trust none of the beneficiaries under which is, at that time, a designated beneficiary under it and whose interest, at that time, in the other trust was held, at all times after the day on which the interest was created, either by it or by persons who were exempt because of subsection 149(1) from tax under Part I on all of their taxable income;

- under subparagraph (*d*)(iv) of the definition, a person (including a trust) or partnership that

  - is a designated beneficiary under the other trust because of paragraph (*c*) of the definition (i.e., a person who is, because of subsection 149(1), exempt from tax under Part I on all or part of their taxable income and who acquired an interest in the particular trust after October 1, 1987 directly or indirectly from a beneficiary under the particular trust) or because of paragraph (*e*) of the definition, or

  - would, based on the assumptions set out it in clause (*d*)(iv)(B), be a designated beneficiary under the particular trust because of paragraph (*c*) or (*e*) of the definition.

Note that a person or partnership that is a beneficiary of the other trust need only be described in any of one of subparagraphs (*d*)(i) to (iv) in order for the other trust to be a designated beneficiary of the particular trust. Note also that references in paragraph (*d*) of the definition to the expression "resident in Canada" are removed as these are unnecessary given that paragraph (*a*) of the definition provides that a non-resident person is a designated beneficiary.

Paragraph (*d*) of the definition is also amended to provide that the other trust will not be treated, under that paragraph, as a designated beneficiary of the particular trust if it is a testamentary trust, a mutual fund trust, or a trust that is exempt because of subsection 149(1) from tax under Part I on all or part of its taxable income. However, these excluded trusts may be treated as designated beneficiaries of the particular trust under paragraphs (*a*) or (*c*) of that definition (e.g., a non-resident testamentary trust).

Amended paragraph (*e*) of the definition provides, in new subparagraph (*e*)(i), that a designated beneficiary of a particular trust includes a particular partnership any of the members of which is another partnership. However, no such other partnership will cause the particular partnership to be a designated beneficiary under the particular partnership if

- all such other partnerships are Canadian partnerships (as defined in subsection 102(1) of the Act),

- the interest of each such other partnership in the particular partnership is held, at all times after the day on which the interest was created, by the other partnership or by persons who were exempt because of subsection 149(1) from tax under Part I on all of their taxable income,

- the interest of each member, of each such other partnership, that is a person exempt because of subsection 149(1) from tax under Part I on all or part of its taxable income was held, at all times after the day on which the interest was created, by that member or by persons who were exempt because of subsection 149(1) from tax under Part I on all of their taxable income, and

- the particular partnership's beneficial interest in the particular trust is held, at all times after the day on which the interest was created, by the particular partnership or by persons who were exempt because of subsection 149(1) from tax under Part I on all of their taxable income.

Under subparagraphs (*e*)(ii) to (iv), a particular partnership will be a designated beneficiary under a particular trust if any one of the partnership's members is a non-resident person, a non-resident-owned investment corporation, or a specified person. For this purpose, a specified person means a trust that is a designated beneficiary of the particular trust because of paragraph (*d*) of the definition or a trust that would be such a designated beneficiary on the following assumptions: the other trust were at that time a beneficiary under the particular trust whose interest as a beneficiary under the particular trust were

- acquired from each person or partnership from whom the particular partnership acquired its interest as a beneficiary under the particular trust, and

- held at all times after the later of October 1, 1987 and the day on which the particular partnership's interest as a beneficiary under the particular trust was created, by the same persons or partnerships that held at those times that interest of the particular partnership.

New subparagraph (*e*)(v) of the definition provides that a particular partnership will be a designated beneficiary of a particular trust if any of the members of the particular partnership is a person exempt because of subsection 149(1) from tax under Part I on all or part of its taxable income, unless the interest of the particular partnership in the particular trust was held, at all times after the day on which the interest was created, by the particular partnership or by persons who were exempt because of subsection 149(1) from tax under Part I on all of their taxable income.

Note that, for the purposes of the definition "designated beneficiary", a new rule in section 132.2 applies in respect of certain trust units acquired by a beneficiary under a "qualifying exchange" (as defined in subsection 132.2(1)). For more detail, see the commentary on section 132.2.

It will be proposed to amend paragraph 210.2(3)(*b*) to ensure that subsection 210.2(3) does not apply to a non-resident person that would be a designated beneficiary under the trust if the definition "designated beneficiary" in subsection 210(1) were read without reference to its paragraph (*a*). It also will be proposed to amend subsection 252(3) of the Act so that the reference in that subsection to existing subparagraph 210(*c*)(ii) is changed to a reference to new subparagraph (*c*)(ii) of the definition "designated beneficiary" in subsection 210(1).

These amendments apply to the 1996 and subsequent taxation years.

**"designated income"**

The tax under Part XII.2 of the Act is calculated by reference to a trust's "designated income" (as determined under subsection 210.2(2)).

Subsection 210.2(2) is being repealed and the definition "designated income" is now found in subsection 210(1) of the Act.

Paragraphs (*a*), (*b*) and (*d*) of the new definition "designated income" in subsection 210(1) are largely unchanged from the equivalent provisions found in repealed subsection 210.2(2).

Paragraph (*c*) of the new definition replaces paragraph 210.2(2)(*b*). Under subparagraph (*c*)(i), designated income is calculated by reference to taxable capital gains and allowable capital losses from dispositions of the trust's taxable Canadian property. Subparagraph (*c*)(ii) provides that a trust's designated income is also calculated by reference to taxable capital gains and allowable capital losses from a disposition by the trust of particular property (other than property described in any of subparagraphs 128.1(4)(*b*)(i) to (iii) of the Act).

In this context, particular property (or property for which the particular property is a substitute) must be property (referred to in this commentary as the "transferred property") that was transferred to a particular trust in circumstances in which subsection 73(1) or 107.4(3) of the Act applied. This condition will be met whether the particular trust is the trust in respect of which the designated income is being determined, or any other trust to which the transferred property was transferred in circumstances in which subsection 73(1) or 107.4(3) applied and that subsequently transferred, directly or indirectly, the property to the trust in respect of which the designated income is being determined.

In addition, clauses (*c*)(ii)(A) and (B) of the definition require

- that it be reasonable to conclude that the transferred property was, at a particular time, transferred to the particular trust in anticipation of the emigration of a person beneficially interested at the particular time in the particular trust and that a person (whether the anticipated person or another) beneficially interested at that time in the particular trust subsequently ceases to reside in Canada, or

- at the particular time that the transferred property was transferred to the particular trust, that the terms of the particular trust satisfy the conditions in subparagraph 73(1.01)(*c*)(i) or (iii) of the Act and that it be reasonable to conclude that the transfer was made in connection with the cessation of residence, on or before that time, of a person who was, at that time, beneficially interested in the particular trust and a spouse or common-law partner, as the case may be, of the transferor of the transferred property to the particular trust.

These amendments generally apply for the 1996 and subsequent taxation years. Subparagraph (*c*)(ii) of the definition applies, in

effect, to dispositions, of property by a trust, that occur after December 20, 2002.

**Application of Part XII.2**

ITA
210(2)

Section 210.1 of the Act provides a list of types of trusts to which Part XII.2 does not apply.

Section 210.1 is being repealed. The list of types of trusts to which Part XII.2 does not apply is now found in new subsection 210(2). New subsection 210(2), consequential on the amendments to the definition "designated beneficiary" (described in the commentary above), also clarifies that it applies only to determine to which trusts the special Part XII.2 tax does not apply. Subsection 210(2) does not apply, for example, to determine whether a trust referred to in that subsection may have a designated beneficiary.

References in the Act to section 210.1 (e.g., see subsection 210.2(1.1)) will be proposed to be amended to reflect its repeal and its substantive re-enactment as new subsection 210(2).

This amendment applies to the 1996 and subsequent taxation years.

**Clause 114**

**Taxation of Non-Residents**

Non-resident Withholding Tax - Interest

ITA
212(1)(*b*)(xiii)

Securities lending arrangements often include an obligation for one party to compensate the other for certain income amounts. In the absence of special rules, these compensation payments may be subject to tax under Part XIII if they are paid by a person resident in Canada to a non-resident person.

New subparagraph 212(1)(*b*)(xiii) exempts from tax under Part XIII certain interest compensation payments made to a non-resident by a borrower resident in Canada under a securities lending arrangement. For this exemption to apply,

- the payments must be made by the borrower in the course of carrying on its business outside of Canada; and
- the borrowed securities must be issued by a non-resident issuer.

This amendment applies to securities lending arrangements entered into after May 1995, except that, before 2002, the reference to "subparagraph 260(8)(*c*)(i)" should be read as "subparagraph 260(8)(*a*)(i)".

**Estate and Trust Income**

ITA
212(1)(*c*)

The French version of paragraph 212(1)(*c*) is amended to replace the term "paiement" with the term "distribution" for consistency with other provisions of the Act dealing with amounts distributed by trusts and estates. This amendment will come into force on Royal Assent.

**Rents, Royalties, etc.**

ITA
212(1)(*d*)

Paragraph 212(1)(*d*) of the Act describes various amounts, in the nature of rent, royalties and similar payments, on which tax under Part XIII of the Act is imposed. Subparagraphs 212(1)(*d*)(vi) through (xi) list payments to which the tax does not apply. Two new exclusions are added to paragraph 212(1)(*d*).

First, subparagraph 212(1)(*d*)(xi), which currently provides that Part XIII tax does not apply to payments made to an arm's length person for the use of property that is an aircraft, certain attachments thereto as well as to spare parts for such property, is amended, applicable after July 2003, to also apply to air navigation equipment utilized in the provision of services under the *Civil Air Navigation Services Commercialization Act*, and to computer software that is necessary to the operation of that equipment that is used by the payer for no other purpose.

Second, new subparagraph 212(1)(*d*)(xii) clarifies that subsection 212(5) of the Act, which is amended as described below, is the sole provision in Part XIII that applies the tax to payments for rights in or to use a film or video that is used or reproduced in Canada. This change applies for the 2000 and subsequent taxation years.

**Restrictive Covenant Amount**

ITA
212(1)(*i*)

New paragraph 212(1)(*i*) of the Act includes, as amounts subject to the withholding tax, two amounts. First, the withholding tax applies to an amount in respect of a restrictive covenant to which new subsection 56.4(2) applies. Second, the withholding tax applies to an amount to which new paragraph 56(1)(*m*) applies (an amount received on a bad debt previously deducted).

New paragraph 212(1)(*i*) applies to amounts paid or credited after October 7, 2003.

**Exempt Dividends**

ITA
212(2.1)

New subsection 212(2.1) is added to exempt from Part XIII tax certain dividend compensation payments made to a non-resident by a Canadian securities borrower under a securities lending arrangement if

- the payments were deemed to be dividends by subparagraph 260(8)(*c*)(i) of the Act;
- the payments were made by the borrower in the course of carrying on its business outside of Canada; and
- the borrowed securities were issued by a non-resident issuer.

This amendment applies to securities lending arrangements entered into after May 1995, except that, before 2002, the reference to "subparagraph 260(8)(*c*)(i)" should be read as "subparagraph 260(8)(*a*)(i)".

**Replacement Obligations**

ITA
212(3)

Among the exceptions to the imposition of tax under Part XIII of the Act on interest is one found in subparagraph 212(1)(*b*)(vii) for interest paid by a corporation resident in Canada on its medium- and long-term arm's length debt. Subsection 212(3), which applies for the purpose of subparagraph 212(1)(*b*)(vii), allows a corporation in

certain circumstances of financial difficulty to treat a debt obligation that replaces another as having been issued when that other obligation was issued. The circumstances in which this is possible are set out in paragraphs 212(3)(*a*) to (*c*). Paragraph 212(3)(*b*) requires that, for the subsection to apply, it must be possible to regard the proceeds of the replacement borrowing as being used in financing an active business that was carried on in Canada, by the issuing company or one with which it does not deal at arm's length, immediately before the replacement obligation was issued.

There is no clear basis in tax policy for this requirement. The condition in paragraph 212(3)(*b*) is repealed for replacement debt obligations that are issued after 2000.

**Rent and Other Payments**

ITA
212(13)

Subsection 212(13) of the Act imposes non-resident withholding tax on certain payments made by one non-resident to another non-resident. Subsection 212(13) is amended to add new paragraph (*g*), which imposes non-resident withholding tax on amounts paid or credited by a non-resident for a restrictive covenant to which paragraph 56.4(2) of the Act applies, or an amount to which paragraph 56(1)(*m*) of the Act applies (an amount received on a bad debt previously deducted), if the amount affects, or is intended to affect, in any way whatever,

- the acquisition or provision of property or services in Canada,
- the acquisition or provision of property or services outside Canada by a person resident in Canada, or
- the acquisition or provision outside of Canada of a taxable Canadian property.

New paragraph 212(13)(*g*) applies to amounts paid or credited after October 7, 2003.

## Application of Part XIII Tax Where Non-Resident Operates in Canada

ITA
212(13.2)

Subsection 212(13.2) of the Act is one of several provisions that extend Part XIII tax to apply in particular circumstances - in this case, for the most part, the payment by a non-resident of royalties and similar amounts in respect of a Canadian income source. The principle that underlies subsection 212(13.2) is that if a non-resident has Canadian-source business or resource income, and can deduct in computing that income (strictly speaking, in computing "taxable income earned in Canada") a payment to another non-resident, that payment ought to be treated for purposes of Part XIII tax as though it had been made by a person resident in Canada. This is accomplished by treating the first non-resident - the one making the payment - as a person resident in Canada for those purposes.

In its current form, subsection 212(13.2) applies only if the non-resident making the payment carries on business principally in Canada, manufactures or processes goods in Canada or carries out any of various resource activities here. On the other hand, the rule does not explicitly link that business or activity to the deductibility of the payment: it can be read as applying whether or not the payment is made in relation to the particular business or activity.

Accordingly, subsection 212(13.2) is amended to apply in respect of any portion of a payment (other than one to which the generally comparable rule in subsection 212(13) applies) made by one non-resident person to another that is deductible in computing the first non-resident's taxable income earned in Canada from any source. The only exceptions are payments that are deductible in respect of treaty-protected businesses or treaty-protected properties (as defined in subsection 248(1) of the Act).

This amendment applies to amounts paid or credited under obligations entered into after December 20, 2002.

**Clause 114.1**

**Deemed Payments**

ITA
214(3)

The French version of paragraph 214(3)(*k*) of the Act is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or her. This amendment will come into force on Royal Assent.

**Clause 115.1**

**Security for Tax on Distributions of Taxable Canadian Property to Non-resident Beneficiaries**

ITA
220(4.6) and (4.61)

The French version of subsections 220(4.6) and (4.61) of the Act is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or her. This amendment will come into force on Royal Assent.

**Clause 116.1**

**Tax Shelters**

**Definitions**

ITA
237.1(1)

Subsection 237.1(1) of the Act provides definitions of terms that apply for the purpose of tax shelter identification and the definition of "tax shelter investment" in subsection 143.2(1) of the Act. The definition "gifting arrangement" includes an arrangement in respect of which it may reasonably be expected, having regard to representations made, that if a taxpayer makes a gift or political contribution under the arrangement, a person (whether or not it is the taxpayer) will incur an indebtedness in respect of which recourse is limited. This definition is amended in respect of gifts and contributions made after

6:00 p.m. (EST), December 5, 2003, to also refer to a limited-recourse debt determined under new subsection 143.2(6.1) of the Act. For additional details regarding limited-recourse debt in respect of a gift, see the commentary to subsection 143.2(6.1).

**Clause 118**

**Interpretation**

**Definitions**

ITA
248(1)

**"disposition"**

The expression "disposition" is used throughout the Act, particularly in provisions relating to transactions involving property.

The definition "disposition" was added to subsection 248(1) by S.C. 2001, chapter 17, ss. 188(5) [formerly Bill C-22]. In general, that definition is applicable to transactions and events that occur after December 23, 1998. The former definition "disposition" was contained in section 54 of the Act, applicable to transactions and events that occurred before December 24, 1998.

Under the definition "disposition" in subsection 248(1), a "disposition" of any property includes a transaction or an event described in any of paragraphs (*a*) to (*d*) of that definition but does not include a transaction or an event described in any of paragraphs (*e*) to (*m*) of that definition.

Under subparagraph (*b*)(i) of that definition, a disposition of a property includes any transaction or event by which, where the property is a share, bond, debenture, note, certificate, mortgage, agreement of sale or similar property, or an interest in it, the property "is redeemed in whole or in part or is cancelled".

The definition "disposition" in subsection 248(1) is amended in the following ways.

First, subparagraph (*b*)(i) of the definition now provides that a disposition of property includes any transaction or event by which, where the property is a share, bond, debenture, note, certificate, mortgage, agreement of sale or similar property, or an interest in it, the property "is in whole or in part redeemed, acquired or cancelled".

This amendment makes it clear that a disposition will also include a transaction or event by which the property is acquired.

Second, paragraph (*n*) is added to the definition. New paragraph (*n*) provides that a redemption, an acquisition or a cancellation of a share, or of a right to be issued a share, (which share or which right, as the case may be, is referred to as the "security") of the capital stock of a corporation (the "issuing corporation") held by another corporation (the "disposing corporation") is considered not to be a "disposition" in the case where

- the redemption, acquisition or cancellation occurs as part of a merger or combination of two or more corporations (including the issuing corporation and the disposing corporation) to form one corporate entity (referred to as the "new corporation").

- the merger or combination is

  - an amalgamation (within the meaning assigned by subsection 87(1) of the Act) to which subsection 87(11) of the Act does not apply,

  - an amalgamation (within the meaning assigned by subsection 87(1)) to which subsection 87(11) applies, if the issuing corporation and the disposing corporation are described by subsection 87(11) as the parent and the subsidiary, respectively, or

  - a foreign merger (within the meaning assigned by subsection 87(8.1) of the Act), and

- either

  - the disposing corporation receives no consideration for the security, or

  - in the case of a foreign merger (within the meaning assigned by subsection 87(8.1)), the disposing corporation receives no consideration for the security other than property that was, immediately before the foreign merger, owned by the issuing corporation and that, on the foreign merger, becomes property of the new corporation.

Both amendments apply to redemptions, acquisitions and cancellations that occur after December 23, 1998, and, where the redemption, acquisition or cancellation takes place before December 21, 2002, the Minister of National Revenue shall, notwithstanding subsections 152(4) to (5) of the Act, make any

assessment of a taxpayer's tax, interest and penalties payable under the Act for any taxation years that include the time at which such a redemption, acquisition or cancellation occurred that is necessary to take into account the application of the amendments.

In connection with redemptions, acquisitions and cancellations that occur before December 24, 1998, see the commentary to new subsection 248(1.1) of the Act.

Third, the definition "disposition" in subsection 248(1) is also amended by restricting the circumstances in which a transfer of property between trusts will not be treated as a disposition. In particular, paragraph (*f*) of the definition is amended so that a transfer of property from a trust to another trust will avoid, under that paragraph, characterization as a disposition only if both trusts are, at the time of the transfer, resident in Canada.

This amendment applies to transfers that occur after Announcement Date.

**"dividend rental arrangement"**

A "dividend rental arrangement" is, in general terms, an arrangement under which one person receives a dividend on a share that has been borrowed from another person who retains the risk of loss or opportunity for gain from fluctuations in the share value. To clarify its application where a partnership is a party to the arrangement, the definition is restructured and amended; its language is also updated in certain respects.

Under the amended definition, the "person" who is the subject of the arrangement - that is, the person who enters into the arrangement in order to receive a dividend - may be a partnership or a person as otherwise defined.

Existing paragraph (*c*) of the definition ensures that the definition includes an arrangement under which a corporation receives a taxable dividend that would be deductible but for subsection 112(2.3) of the Act, and is obligated to make dividend compensation payments. This paragraph is replaced by new paragraph (*b*), which adds to the arrangements described one in which it is not the corporation receiving the dividend that is obligated to make the compensation payment, but rather a partnership of which the corporation is a member.

At first reading, new paragraph (*b*) may seem asymmetrical, in that it expressly covers the case where a partnership is obligated to make the compensation payment, but not the case where a partnership receives

the taxable dividend. In fact, the paragraph covers both: since in the latter case the corporate partner is itself already considered to receive the dividend, it is not necessary to add a reference to the partnership in that regard.

The reference to "subsection 260(5)" in this definition is replaced with "subsection 260(5.1)" consequential to the amendments to section 260. This amendment applies to paragraph (*d*) of the former definition and clause (*b*)(ii)(B) of the amended definition.

The amendment to paragraph (*d*) of the former definition applies between January 1, 2002 and December 20, 2002 unless an election noted below is filed.

The amended definition applies to arrangements made after December 20, 2002; it also applies to an arrangement made after November 2, 1998 and before the day after December 20, 2002, if the parties jointly elect in writing filed with the Minister of National Revenue within 90 days after this Act has been assented to, except that before 2002 the reference to "subsection 260(5.1)" in the amended definition should be read as "subsection 260(5)".

**"qualifying environmental trust"**

The French version of the definition of "qualifying environmental trust", in subsection 248(1) of the Act, is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or her. This amendment will come into force on Royal Assent.

**Non-Disposition Before December 24, 1998**

ITA
248(1.1)

The definition "disposition" was added to subsection 248(1) of the Act by S.C. 2001, chapter 17, subsection 188(5) [formerly Bill C-22]. In general, that definition applies to transactions and events that occur after December 23, 1998. The former definition "disposition" was contained in section 54 of the Act, applicable to transactions and events that occurred before December 24, 1998.

New paragraph (*n*) is added to the definition "disposition" in subsection 248(1), applicable to redemptions, acquisitions and cancellations of certain securities that occur after December 23, 1998. For more detail, see the commentary to subsection 248(1).

New subsection 248(1.1) of the Act is added to deal, in a corresponding fashion, with such redemptions, acquisitions and cancellations that occurred before December 24, 1998.

New subsection 248(1.1) provides that a redemption, an acquisition or a cancellation, at any particular time after 1971 and before December 24, 1998, of a share, or of a right to acquire a share, (which share or which right, as the case may be, is referred to as the "security") of the capital stock of a corporation (referred to as the "issuing corporation") held by another corporation (referred to as the "disposing corporation") is not a disposition of the security within the meaning of the definition "disposition" in section 54 (as that section read in its application to transactions and events that occur at the particular time), if

- the redemption, acquisition or cancellation occurred as part of a merger or combination of two or more corporations (including the issuing corporation and the disposing corporation) to form one corporate entity (referred to as the "new corporation"),

- the merger or combination is

  - an amalgamation (within the meaning assigned by subsection 87(1) of the Act as it read at the particular time) to which subsection 87(11) of the Act if in force, and as it read, at the particular time did not apply,

  - an amalgamation (within the meaning assigned by subsection 87(1) as it read at the particular time) to which subsection 87(11) if in force, and as it read, at the particular time applies, if the issuing corporation and the disposing corporation are described by subsection 87(11) (if in force, and as it read, at the particular time) as the parent and the subsidiary, respectively, or

  - a foreign merger (within the meaning assigned by subsection 87(8.1) of the Act as it read at the particular time), and

- either

  - the disposing corporation received no consideration for the security, or

  - in the case of a foreign merger (within the meaning assigned by subsection 87(8.1) as it read at the particular time), the disposing corporation received no consideration for the security other than property that was, immediately before the foreign

merger, owned by the issuing corporation and that, on the foreign merger, became property of the new corporation.

New subsection 248(1.1) applies on Royal Assent and, notwithstanding subsections 152(4) to (5) of the Act, the Minister of National Revenue may make any assessment of a taxpayer's tax, interest and penalties payable under the Act for a taxation year that includes the time at which a redemption, acquisition or cancellation occurred that is necessary to take into account the application of new subsection 248(1.1) in respect of the redemption, acquisition or cancellation.

**Occurrences as a Consequence of Death**

ITA
248(8)

The French version of subsection 248(8) of the Act is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or her. This amendment will come into force on Royal Assent.

**Goods and Services Tax - Input Tax Credit and Rebate**

ITA
248(16)

Subsection 248(16) of the Act provides rules under which amounts received by, or credited to, a taxpayer as an input tax credit or rebate with respect to the goods and services tax (GST) are deemed to be assistance from a government received by a taxpayer. As a consequence, such amounts are either included in income or reduce the cost or capital cost of the related property, or the amount of the related expenditure or expenditure pool, for tax purposes.

Subsection 248(16) also specifies the time at which the receipt (or credit) of an input tax credit or rebate is deemed to be received as assistance. With respect to input tax credits, subparagraph 248(16)(*a*)(i) provides that the assistance (i.e., the input tax credit) is considered to be received by a taxpayer at the time the GST in respect of the input tax credit was paid or became payable by the taxpayer if the GST was paid or became payable in the same reporting period under the *Excise Tax Act* in which the input tax credit was claimed. If a taxpayer does not claim the input tax credit in the same reporting period in which the GST was paid or became payable, subparagraph 248(16)(*a*)(ii) includes the amount of assistance in the taxpayer's income for the taxation year that includes

the end of the reporting period in which the taxpayer claimed the input tax credit.

Subsection 248(16) is amended in three respects for input tax credits that become eligible to be claimed in taxation years that begin after December 20, 2002.

First, subparagraph 248(16)(*a*)(i) is amended to extend its application to cases where the input tax credit is claimed by a taxpayer in a reporting period that is subsequent to the period in which the related GST was paid or became payable if

- the taxpayer's threshold amount (as determined under subsection 249(1) of the *Excise Tax Act*) is greater than $500,000 for the taxpayer's fiscal year (as defined by that Act) that includes the earlier of the time that the GST in respect of the input tax credit was paid and the time that it became payable, and

- the taxpayer claimed the input tax credit at least 120 days before the end of the normal reassessment period (as determined under subsection 152(3.1) of the *Income Tax Act*) for the taxpayer in respect of the taxation year that includes that earlier time.

In general, the change to this subparagraph means that an input tax credit of a taxpayer (who is a GST filer with a threshold amount greater than $500,000 for GST purposes) is considered to have been received at the time the related GST was paid or became payable, even though the input tax credit is claimed in a later GST reporting period. However, this is the case only if the taxpayer claims the input tax credit at least 120 days before the taxation year in which the GST was paid or became payable becomes statute-barred for income tax purposes.

Second, subparagraph 248(16)(*a*)(ii) is amended to provide that an input tax credit is considered to be received at the end of the reporting period in which it is claimed only if

- subparagraph 248(16)(*a*)(i) does not apply, and

- the taxpayer's threshold amount (as determined under subsection 249(1) of the *Excise Tax Act*) is $500,000 or less for the fiscal year of the taxpayer that includes the earlier of the time that the GST in respect of the input tax credit was paid or became payable.

Thus, subparagraph 248(16)(*a*)(ii) does not apply if subparagraph 248(16)(*a*)(i) applies. Where subparagraph 248(16)(*a*)(i) does not apply, subparagraph 248(16)(*a*)(ii) provides that the input tax credit is considered to have been received at the end of the reporting period in

which it is claimed only if the taxpayer's threshold amount for GST purposes was $500,000 or less at the time the GST was paid or became payable.

Third, new subparagraph 248(16)(*a*)(iii) is added to apply in any other case. If applicable, that subparagraph provides that the input tax credit is considered to have been received on the last day of the taxpayer's earliest taxation year

- that begins after the taxation year that includes the earlier of the time that the GST in respect of the input tax credit was paid and the time that it became payable, and

- for which the normal reassessment period for the taxpayer ends at least 120 days after the time at which the input tax credit was claimed.

Reference should also made to the commentary to new subsection 248(17.1) of the *Income Tax Act* which provides a special rule in respect of the timing of a claim in respect of certain input tax credits assessed under the *Excise Tax Act*.

**Quebec Sales Tax - Input Tax Refund and Rebate**

ITA
248(16.1)

New subsection 248(16.1) of the Act provides special rules for amounts received, or credited to, a taxpayer as an input tax refund or rebate in respect of Quebec sales tax. Such amounts are either included in a taxpayer's income or reduce the cost or capital cost of the related property, or the amount of the related expenditure or expenditure pool, for tax purposes.

In general, an input tax refund in respect of Quebec sales tax may - depending on the circumstances - have to be included in a taxpayer's income in the taxation year in which the taxpayer may first claim the refund, rather than the year in which it is received. A rebate of Quebec sales tax is included in income at the time the rebate is received or credited. For a more detailed explanation of the application of subsection 248(16.1), reference should be made to the commentary accompanying amendments to subsection 248(16), which provides analogous special rules in respect of the timing of the inclusion in income of certain input tax credits and rebates assessed under the *Excise Tax Act*.

Subsection 248(16.1) applies in respect of Quebec input tax refunds and rebates that become eligible to be claimed in taxation years that begin after Announcement Date.

**Application of Subsection (16) to Passenger Vehicles and Aircraft**

ITA
248(17)

Subsection 248(17) of the Act applies in the case of an input tax credit in respect of a passenger vehicle or aircraft claimable by an individual or partnership where the credit is determined by reference to capital cost allowance in respect of the vehicle or aircraft (i.e., where there is less than exclusive use in commercial activity). Subsection 248(17) is amended to reflect the amendments made to subsection 248(16) as described in the commentary to that subsection.

The amendments to subsection 248(17) apply in respect of input tax credits that become eligible to be claimed in taxation years that begin after December 20, 2002.

**Application of Subsection (16.1) to Passenger Vehicles and Aircraft**

ITA
248(17.1)

New subsection 248(17.1) of the Act applies in the case of an input tax refund of Quebec sales tax, in respect of a passenger vehicle or aircraft, claimable by an individual or partnership where the credit is determinable by reference to capital cost allowance in respect of the vehicle or aircraft (that is, where there is less than exclusive use in commercial activity). In general, this subsection defers the time the input tax refund is considered to be received for income tax purposes to the taxation year or fiscal period following that in which Quebec sales tax in respect of the property is considered as payable for the purposes of determining the input tax refund. This avoids circularity with subsection 248(16.1). The provision preserves the proper timing between the input tax refund entitlement and the adjustment to the capital cost. This change applies in respect of Quebec input tax refunds that become eligible to be claimed in taxation years that begin after Announcement Date.

**Input Tax Credit on Assessment**

ITA
248(17.2)

New subsection 248(17.2) of the Act determines, in respect of input tax credits that become eligible to be claimed in taxation years that begin after December 20, 2002, the time at which an input tax credit is considered to have been claimed in respect of certain input tax credit assessments made under the *Excise Tax Act* (ETA).

This subsection provides that, if an amount in respect of an input tax credit is deemed by subsection 296(5) of the ETA to have been claimed in a return or application filed under Part IX of that Act, the input tax credit is deemed to have been claimed for the GST reporting period that includes the time the Minister of National Revenue makes the GST assessment.

Accordingly, the rule in clause 248(16)(*a*)(i)(A) of the *Income Tax Act* (ITA) relating to the time at which an input tax credit is considered to have been received cannot apply to an input tax credit to which subsection 296(5) of the ETA applies. However, the other rules in paragraph 248(16)(*a*) of the ITA that determine the time at which an input tax credit is received are to be applied on the basis that an input tax credit (to which subsection 296(5) of the ETA applies) is not claimed by the taxpayer until the reporting period that includes the time at which the input tax credit is actually assessed - i.e., not the reporting period to which the assessment relates but the reporting period in which the input tax credit is deemed to be claimed for GST purposes.

**Quebec Input Tax Credit on Assessment**

ITA
248(17.3)

New subsection 248(17.3) of the Act provides that an input tax refund of Quebec sales tax, that is deemed to be claimed by section 30.5 of *An Act respecting the Quebec Revenue Minister*, is deemed to be claimed for the reporting period under *An Act respecting Quebec Sales Tax* that includes the day on which an assessment is issued to the taxpayer indicating that the refund has been allocated to the taxpayer. This change applies in respect of Quebec input tax refunds and rebates that become eligible to be claimed in taxation years that begin after Announcement Date.

### Repayment of Quebec Input Tax Refund

ITA
248(18.1)

New subsection 248(18.1) of the Act provides that an amount added in determining net tax of a taxpayer under *An Act respecting Quebec Sales Tax* in respect of an input tax refund relating to a property or service that had previously been deducted in computing such net tax is treated as assistance repaid under a legal obligation to repay that assistance. Such an amount could be so added under Quebec law pursuant to an assessment of Quebec sales tax. As a consequence, such an amount will either be deducted in computing income under paragraph 20(1)(*hh*) or will increase the cost or capital cost of the related property or the amount of the related expenditure or expenditure pool for tax purposes (as provided under subsection 13(7.1), paragraphs 37(1)(*c*) and 53(2)(*k*) and under the definitions "cumulative Canadian exploration expense" in subsection 66.1(6), "cumulative Canadian development expense" in subsection 66.2(5) and "cumulative Canadian oil and gas property expense" in subsection 66.4(5)). This change applies after Announcement Date.

### Trust-to-trust Transfers

ITA
248(25.1)

Subsection 248(25.1) of the Act applies where there is a transfer of a property from a particular trust to another trust (other than a RRSP trust or RRIF trust) in circumstances to which paragraph (*f*) of the definition "disposition" in subsection 248(1) (see the commentary above) applies. The result of the application of paragraph (*f*) is that the transfer does not constitute a disposition. Where this is the case, subsection 248(25.1) deems the other trust after the particular time to be the same trust as, and a continuation of, the particular trust.

Subsection 248(25.1) is amended, for greater certainty, to ensure that where the transferred property is deemed under a number of specified provisions to be taxable Canadian property of the particular trust, the property continues to be taxable Canadian property of the other trust.

This amendment applies in respect of transfers that occur after December 23, 1998.

**Gifts and Contributions**

ITA
248(30) to (38)

At common law, it is generally the view that a gift includes only a property transferred voluntarily, without any contractual obligation and with no advantage of a material character returned to the transferor.

In contrast, under section 1806 of the *Civil Code of Quebec* ("CCQ"), a gift in Quebec is a contract by which ownership of property is transferred by gratuitous title. However, the rights of ownership may be separated, such that it may be possible for a transferor to transfer part of the rights of ownership without any material advantage returned (i.e., by way of gift) and to transfer the other part separately for consideration. It is therefore possible, in Quebec, to sell a property to a charity at a price below fair market value, resulting in a gift of the difference.

Under both the common law and the CCQ, it is generally accepted that a transfer of property is not a gift unless the donor is impoverished by the transfer to the benefit of the donee and it is the donor's intention to enrich the donee without consideration.

At common law there is generally no ability to separate the rights of ownership of a single property in the course of making a gift. As such, at common law a contract to dispose of a property to a charity at a price below fair market value would not generally be considered to include a gift.

Nevertheless, there have been certain decisions made under the common law where it has been found that a transfer of property to a charity was made partly in consideration for services and partly as a gift.

Subsections 248(30), (31) and (32) are added to the Act to clarify the circumstances under which taxpayers and donees may be eligible for tax benefits available under the Act in respect of the impoverishment of a taxpayer in favour of a donee. In addition to the clarification provided by these new rules, on December 24, 2002, the Canada Customs and Revenue Agency released guidelines (*Income Tax Technical News No. 26*) that describe how it will apply the new rules to various situations and fundraising methods commonly used in the charitable sector. Subsections 248(34), (35), (36), (37) and (38) are added to the Act to provide technical rules, regarding the values of property transferred and benefits receivable, that apply in calculating the eligible amount of a gift or political contribution.

In general, these provisions are intended to reflect the policy that the amount eligible for an income tax benefit to a donor, by way of a charitable donation deduction or credit or a political contributions tax credit, should reflect the economic impact on the donor (before considering the income tax benefit) of the gift or contribution.

**Eligible Amount of Gift or Monetary Contribution**

ITA
248(30)

New subsection 248(30) of the Act, which applies in respect of gifts and political contributions made after December 20, 2002, defines the eligible amount of a gift or contribution as the amount by which the fair market value of the property that is the subject of the gift or contribution exceeds the amount of the advantage, if any, in respect of the gift or contribution. Subsection 248(30) is added concurrently with amendments to subsections 110.1(1) and 118.1(1) of the Act, which describe the types of gifts in respect of which an eligible amount will qualify for a deduction (for corporations) or a tax credit (for individuals). The amount of the advantage in respect of a gift or contribution is described in new subsection 248(31) of the Act.

It is proposed that subsections 3501(1), (1.1) and (6) of the Regulations be amended to provide that official receipts issued by a registered organization in respect of a gift made after December 20, 2002 contain, in addition to the information already prescribed, the eligible amount of the gift.

**Amount of Advantage**

ITA
248(31)

New subsection 248(31), which generally applies in respect of gifts or political contributions made after December 20, 2002, describes the amount of an advantage in respect of a gift or contribution as, in general, the total value of all property, services, compensation or other benefits to which the donor of a property is entitled.

Subsection 248(31) is added concurrently with the addition of subsection 248(30) of the Act, which defines the eligible amount of a gift or contribution, and with the amendment of subsection 127(3) of the Act in respect of contributions to a political party. The amount of an advantage reduces the eligible amount of a gift or contribution.

In general, new subsection 248(31) is intended to apply in respect of any transaction or series of transactions having either the purpose or

the effect of reducing the economic impact to a donor of a gift or contribution. This includes, for instance, situations where a charity invests funds or acquires property in a manner that benefits the donor. The reduction to an eligible amount also includes an advantage that is partial consideration for, or in gratitude for, the gift or contribution, or is in any way related to the gift or contribution. An example would include the option of a donor to satisfy or pay a loan by assigning or transferring to another person a property (including the rights under an insurance policy) that has less economic value than the amount of loan outstanding. Another example would include an assumption of a donor's risk by a charity, where the acquisition, directly or indirectly, of an interest in a property of the donor by the charity may have the effect of reducing the potential loss of the donor from that investment. (However, a tax credit or deduction resulting from a charitable donation is not considered a benefit.)

An advantage may exist even though it is not received at the time of the gift or contribution. For example, it may have been received prior to the time of the gift or may be contingent or receivable in the future. The advantage may accrue either to the donor or to a person not dealing at arm's length with the donor. It is not necessary that the advantage be receivable from the donee.

Paragraph 248(31)(*b*) includes as an advantage any limited-recourse debt in respect of the gift or contribution. For additional details regarding limited-recourse debt, see the commentary to new subsection 143.2(6.1) of the Act.

It is proposed that subsections 2000(1) and (6) and 3501(1), (1.1) and (6) of the Regulations be amended to provide that official receipts issued by a registered organization or political party in respect of a gift or contribution contain, in addition to the information already prescribed, the eligible amount and the amount of the advantage, if any, in respect of the gift or contribution.

**Intention to Give**

ITA
248(32)

For the transfer of property to qualify as a gift, it is necessary that the transfer be voluntary and with the intention to make a gift. At common law, where the transferor of the property has received any form of consideration or benefit, it is generally presumed that such an intention is not present. New subsection 248(32) of the Act, which applies in respect of transfers of property after December 20, 2002 to qualified donees (such as registered charities), allows the opportunity to rebut this presumption. New paragraph 248(32)(*a*) provides that

the existence of an amount of an advantage to the transferor will not necessarily disqualify the transfer from being a gift if the amount of the advantage does not exceed 80% of the fair market value of the transferred property.

> ***Example***
>
> *Mr. Short transfers land and a building with a fair market value of $300,000 to a registered charity. The charity assumes liability for an outstanding $100,000 mortgage on the property. The assumption of the mortgage by the charity does not necessarily disqualify the transfer from being a gift for the purposes of the Act.*
>
> *If the value of the mortgage is equal to the outstanding amount (e.g., the interest rate and terms and conditions are representative of current market conditions), the eligible amount of the gift, in respect of which Mr. Short may be entitled to a tax credit under subsection 118.1(3), is $200,000.*

If the amount of an advantage in respect of a transfer of property exceeds 80% of the fair market value of the transferred property, new paragraph 248(32)(*b*) provides that the transfer will not necessarily be disqualified from being a gift if the transferor can establish to the satisfaction of the Minister of National Revenue that the transfer was made with the intention to make a gift.

> *In the above example, if the amount of the mortgage outstanding had been greater than $240,000, Mr. Short (or the charity on Mr. Short's behalf) could apply to the Minister of National Revenue for a determination as to whether the transfer was made with the intention to make a gift.*

It is generally accepted that the tax benefit available to a taxpayer, by way of a charitable donation deduction or credit, is not considered an advantage or benefit that would reflect a lack of donative intent on the part of a taxpayer. However, there may be circumstances where the intention of a taxpayer to make a gift is in doubt because of the combination of tax and other benefits to the taxpayer. If the primary motivation of a taxpayer for entering into a transaction or series of transactions is to return a profit to the taxpayer by way of a combination of tax and other benefits, the taxpayer may not be impoverished by the transfer of a property to a charity. Subsection 248(32) is not intended to allow a taxpayer to profit by the making of a gift.

**Cost of Property Acquired by Donor**

ITA
248(33)

New subsection 248(33) of the Act, which applies in respect of gifts or political contributions made after December 20, 2002, provides that the cost to a taxpayer of property acquired by the taxpayer in the course of the making of a gift or contribution by the taxpayer is the fair market value of the property at the time of the making of the gift or contribution. The fair market value of such a property is relevant in computing the amount of the advantage in respect of the gift or contribution under subsection 248(31).

**Repayment of Limited Recourse Debt**

ITA
248(34)

New subsection 248(34) of the Act, which applies in respect of gifts or political contributions made after February 18, 2003, generally provides that a repayment of the principal amount of a limited-recourse debt in respect of a gift or political contribution is deemed to be a gift in the year it is paid. However, in some circumstances the total amount of limited-recourse debt and other advantages to the donor may exceed the fair market value of the property transferred to a charity, resulting in no eligible amount to the donor under subsection 248(30) of the Act. In this case, the donor must pay off the excess amount before any amount will be allowed as a gift. Also, a payment financed by other limited-recourse debt or made by way of assignment or transfer of a guarantee, security or similar indemnity or covenant is not recognized for these purposes. For example, the assumption of a taxpayer's limited-recourse debt by another person, in exchange for an insurance policy in favour of the taxpayer that guarantees a particular rate of return on an investment held by any person, would not qualify as a deemed gift under subsection 248(34).

**Deemed Fair Market Value**

ITA
248(35)

New subsection 248(35) of the Act, which applies in respect of gifts made after 6:00 p.m. (EST), December 5, 2003, provides that the fair market value of a property that is the subject of a gift is, for the purposes of determining the eligible amount of a gift under subsection 248(30), deemed to be the lesser of the actual fair market value of the property and its cost to the donor. This rule applies if

the property was acquired in contemplation of its donation or less than three years before the time of donation, unless the donation is made as a consequence of the donor's death. This rule also applies if the property was acquired by the donor as part of a gifting arrangement. For more information on gifting arrangements, refer to the commentary for subsection 237.1(1) of the Act.

**Non-application of Subsection (35)**

ITA
248(36)

New subsection 248(36) of the Act provides exceptions to the application of subsection 248(35) of the Act where the property that is the subject of a gift is an ecological gift, inventory, real property situated in Canada, publicly-traded securities or cultural property, the value of which is certified by the *Cultural Property Export Review Board.*

**Artificial Transactions**

ITA
248(37)

New subsection 248(37) of the Act, which applies in respect of gifts made after 6:00 p.m. (EST), December 5, 2003, prevents a donor from avoiding the application of subsection 248(35) by disposing and reacquiring a property before donating it to a qualified donee. If this is the purpose of any transaction or series of transactions that includes a disposition or acquisition of a property, the cost of the property to the donor for the purpose of subsection 248(35) is deemed to be the lowest cost incurred by the taxpayer at any time to acquire that property or an identical property.

**Substantive Gift**

ITA
248(38)

New subsection 248(38) of the Act, which applies in respect of gifts made after Announcement Date, prevents a donor from avoiding the application of subsection 248(35) by disposing a property (the "substantive gift") to a qualified donee and donating the proceeds, rather than donating the property itself. The provision applies similarly in respect of political contributions. The fair market value of the gift or contribution of the proceeds, for the purpose of determining its eligible amount under subsection 248(30), is deemed to be the lesser of the fair market value of the property sold and its

cost. Subsection 248(38) does not apply if subsection 248(35) would not have applied to a gift by the taxpayer of that property.

**Clause 121**

**Acquisition of Control of a Corporation**

**Acquiring Control**

ITA
256(7)(*a*)

Paragraph 256(7)(*a*) of the Act describes the circumstances where control of a corporation (or a corporation controlled by the corporation) is considered not to have been acquired for the purposes of certain provisions of the Act. That paragraph is amended in two ways.

First, subparagraph 256(7)(*a*)(i) is amended effective with respect to the acquisition of shares after 2000 to add clause (E) which precludes an acquisition of control of a corporation on a distribution (within the meaning assigned by subsection 55(1) of the Act) by a specified corporation (within the meaning assigned by that subsection) if a dividend is received in the course of a spin-off distribution in which no portion of the dividend is treated as a capital gain by the anti-avoidance rule in subsection 55(2) of the Act because of the application of the exception for certain reorganizations under paragraph 55(3)(*b*) of the Act.

> ***Example:***
>
> *Facts:*
>
> *Pubco is a specified corporation under the butterfly rules in section 55 and a person or group of persons does not control it. Pubco owns all of the shares of Subco. In the course of a distribution (as defined by subsection 55(1)), Pubco distributes the Subco shares to Newco, which is established in the course of the reorganization for the purposes of the distribution. The same shareholders that own all of the shares of Pubco own all of the shares of Newco. Because there is no person or group of persons that control Pubco and Newco, an acquisition of control of Subco would occur upon Newco's acquisition of the Subco shares on the distribution despite the fact the same shareholders own Pubco and Newco.*

*Application:*

*In this example, new clause 256(7)(a)(i)(E) provides that there is no acquisition of control of Subco by Newco if Pubco's distribution of its Subco shares to Newco is a distribution to which the anti-avoidance rule in subsection 55(2) does not apply because the distribution complies with the exception in paragraph 55(3)(b).*

Second, new subparagraph 256(7)(*a*)(iii), which applies to the acquisition of shares after 2000, provides that, where there is an acquisition of any shares of a corporation, there is no acquisition of control of the corporation by a related group of persons if each member of each group of persons that controls the corporation was related to the corporation immediately before the change of control.

***Example:***

*Facts:*

*Corporation X has issued 100 common shares with 1 vote per share. There are no other issued shares. Mr. X owns 51% of Corporation X's issued shares. Ms. D who is the daughter of Mr. X owns 49% of the common shares issued by Corporation X. Mr. X has de jure control of Corporation X.*

*Mr. X disposes of 10 shares of Corporation X to Mr. Z, an arm's length person. Consequently, Mr. X no longer has de jure control, and a group of persons acquires de jure control of Corporation X.*

*Application:*

*If Mr. X and Ms. D form a related group of persons that otherwise acquires control of Corporation X upon the disposition of shares by Mr. X, new subparagraph 256(7)(a)(iii) deems no acquisition of control if no other group of persons that includes Mr. Z acquires control of Corporation X. It is a question of fact whether Mr. X and Ms. D form a group of persons that would otherwise acquire control of Corporation X and, if so, whether there exists another group of persons that also acquires control. Depending on the circumstances, Mr. X and Ms. D; Mr. X and Mr. Z; Ms. D and Mr. Z; or Mr. X, Ms. D and Mr. Z could form a group of persons that acquires control of Corporation X. Consequently, new subparagraph 256(7)(a)(iii) applies only if, in this example, Mr. X and Ms. D form a group of persons that control Corporation X and there exists no other group of persons (which includes Mr. Z) that acquires control of Corporation X.*

**Clause 123**

**Securities Lending Arrangements**

ITA
260

Section 260 of the Act sets out special rules that apply to securities lending arrangements.

**Definitions**

ITA
260(1)

Subsection 260(1) of the Act provides definitions that apply for the purposes of the special rules for securities lending arrangements. The existing definitions are modified, and additional definitions are added, as follows:

**"qualified security"**

The securities lending arrangement rules apply only to securities that are qualified securities. A new paragraph (*e*) is added to the definition "qualified security" to include a qualified trust unit.

This new definition applies to securities lending arrangements made after 2001.

**"qualified trust unit"**

A "qualified trust unit" is defined to mean a unit of a mutual fund trust that is listed on a prescribed stock exchange.

This new definition applies to securities lending arrangements made after 2001.

**"securities lending arrangement"**

There are three amendments to the definition "securities lending arrangement".

Paragraph (*a*) of the existing definition provides that in order for there to be a securities lending arrangement, the lender and the borrower of a security must be dealing at arm's length. The amendment to paragraph (*a*) extends the definition to include an arrangement entered into by non-arm's length parties. New paragraph (*e*) provides that where the lender and borrower do not deal with each

other at arm's length, the arrangement must be of a term not exceeding 270 days and must not be part of a series of securities lending arrangements, loans or other transactions intended to be in effect for more than 270 days.

Paragraph (*c*) of the existing definition provides that where a borrowed security is a share, the borrower must be obligated to pay to the lender a dividend compensation payment in order for the transaction to be a securities lending arrangement. This paragraph is amended to apply a comparable requirement in respect of all arrangements. This recognizes and codifies the commercial reality that compensation payments are required to be made by the borrower to the lender in all securities lending arrangements, and not just those arrangements involving shares.

The amendment to paragraph (*c*) applies to arrangements made after 2001. The amendments to paragraphs (*a*) and (*e*) apply to arrangements made after 2002.

**"security distribution"**

"Security distribution" is a newly-defined term, introduced not to effect any substantive change to the relevant rules but only for simplicity and clarity. A security distribution is an amount, in respect of a borrowed security, that is either paid by the issuer of the security (for example as a dividend or a trust distribution) or received as a compensation payment.

This definition applies to securities lending arrangements made after 2001.

**Deemed Compensation Payment**

ITA
260(5) and (5.1)

Subsection 260(5) of the Act, in its current form, treats dividend compensation payments that are received under specified circumstances as dividends. The subsection also, however, denies this dividend treatment where the amount is received by a corporation and one of the main reasons for the corporation entering into the arrangement was to enable it to receive an amount that would be treated as a dividend by the subsection.

Subsection 260(5) is reorganized into two subsections. New subsection 260(5) describes the circumstances under which the compensation payment deeming rule, now found in new subsection 260(5.1), applies. The deeming rule applies where an amount is

received under a securities lending arrangement under one of these circumstances: from a person resident in Canada, from a person not resident in Canada where the amount was paid in the course of carrying on business in Canada through a permanent establishment, or from or by a registered securities dealer. These are essentially the same as the circumstances specified prior to the amendment.

Also, the anti-avoidance rule in this subsection - which currently addresses only the case of an amount that would otherwise be received by a corporation as a dividend - is amended to include all otherwise non-taxable amounts that may be received under a securities lending arrangement, by any person. This amendment recognizes that with the introduction of qualified trust units as "qualified securities," a person may be treated as having received any of several kinds of non-taxable amounts.

New subsection 260(5.1) of the Act treats a given compensation payment as one of three things: a dividend, an amount paid by a trust and having the same characteristics, source and purpose as the "underlying payment" amount paid by the trust directly, or interest. The overall effect of the provision is, in addition to replicating the former dividend deeming rule, to deem compensation payments in respect of payments from a trust to have the same characteristics, source and purpose as if the amounts were paid by the trust.

These amendments apply to securities lending arrangements made after 2001.

**Deductible Compensation Payment Amount**

ITA
260(6)

Subsection 260(6) of the Act limits the extent to which a person who makes a dividend compensation payment under a securities lending arrangement may deduct the payment in computing income from a business or property. In brief, the subsection denies a deduction for any dividend compensation payment made by persons other than registered securities dealers, and provides that registered securities dealers may deduct up to 2/3 of the dividend compensation payments they make.

Amended subsection 260(6) retains this 2/3 dividend compensation payment deduction for registered securities dealers. It also allows any taxpayer - including but not limited to registered securities dealers - a deduction in respect of compensation amounts that are not dividend compensation payments. The amount of this new deduction is computed differently depending on the actions of the taxpayer in

question (the one who made the payment and seeks to deduct it). If the taxpayer has disposed of the borrowed security and has included any resulting gain or loss in computing business income, the compensation amount is fully deductible. In any other case, new subsection 260(6) allows a deduction to the extent of the lesser of (i) the compensation amount and (ii) the amount included in the taxable income of the taxpayer or persons related to it.

Amended subsection 260(6) applies to securities lending arrangements made after 2001.

**Deduction - Compensation Payments**

ITA
260(6.1)(*a*)

Subsection 260(6.1) of the Act provides a deduction for dividend compensation payments made pursuant to certain dividend rental arrangements. The amount deductible is the lesser of the amount the corporation is obligated to pay as compensation under the arrangement and the amount of the dividends received by the corporation under the arrangement that were identified in its return of income as amounts which are not deductible because of subsection 112(2.3) of the Act.

Paragraph 260(6.1)(*a*) of the Act is amended to clarify that the amount described in that paragraph is the total of all amounts that the corporation becomes obligated in the taxation year to pay to another person as compensation under certain dividend rental arrangements.

Also, paragraph 260(6.1)(*a*) of the English version of the Act is amended, as a consequence of the amendments to the definition "dividend rental arrangement" in subsection 248(1) of the Act, by replacing the reference to "paragraphs (*c*) and (*d*)" of that definition to a reference to "paragraph (*b*)" of that definition.

This amendment applies to dividend rental arrangements made after December 20, 2002 and, if the parties jointly elect within 90 days after this Act has been assented to, it also applies to dividend rental arrangements made after November 2, 1998 and on or before December 21, 2002, except that before 2002 the reference to "subsection 260(5.1)" should be read as "subsection 260(5)".

For arrangements made after 2001 and before December 21, 2002 that are not the subject of the election described in the previous paragraph, the definition "dividend rental arrangement" in effect before December 21, 2002 is applicable, except that the reference to

"subsection 260(5)" in that definition should be read as "subsection 260(5.1)".

**Dividend Refund**

ITA
260(7)

Subsection 260(7) of the Act provides that, where a corporation makes a payment which is deemed by the former subsection 260(5) to be a taxable dividend, the corporation will also be entitled to treat the amount as the payment of a dividend for the purposes of section 129 of the Act.

The postamble of the English version of subsection 260(7) is amended to replace the reference "subsection 260(5)" with "subsection 260(5.1)".

This amendment applies to securities lending arrangements made after 2001.

**Non-resident Withholding Tax**

ITA
260(8), (8.1) and (8.2)

Subsection 260(8) of the Act applies special rules, for the purposes of Part XIII of the Act, to payments made under securities lending arrangements. The subsection has two main aspects: rules that ensure the appropriate treatment for Part XIII purposes of compensation payments; and a rule that in certain circumstances will treat a borrower as having paid to a lender a "borrow fee".

The subsection is rearranged into three separate subsections. Amended subsection 260(8) retains the previous rules for compensation payments relating to interest and dividends, confining them to amounts paid on a security that is not a qualified trust unit. Subsection 260(8) also provides for compensation payments made in respect of a borrowed qualified trust unit: these are treated as payments from a trust and as having the same character and composition as the trust payments for which they compensate.

New subsection 260(8.1) provides for a deemed borrow fee, on the same basis as the existing paragraph 260(8)(*b*). New subsection 260(8.2) similarly preserves the effect of the existing postamble to subsection 260(8) in relation to tax treaties.

These subsections apply to securities lending arrangements made after 2001.

**Partnerships**

ITA
260(10), (11), and (12)

A "securities lending arrangement" (SLA) is defined in subsection 260(1) of the Act as a particular transaction between two persons: the "lender" and the "borrower" of a security. A partnership - which for most purposes of the Act is not a person - can be a party to a transaction that would be an SLA if the partnership were a person. In such a case, it is appropriate in policy terms for the arrangement to be treated as an SLA. New subsections (10), (11) and (12) are added to section 260 to bring partnerships within the SLA rules.

New subsection 260(10) provides that, for the purposes of section 260, a person includes a partnership. This allows a partnership to be either the borrower or the lender in respect of an SLA. The subsection also treats a partnership as a registered securities dealer, if all of its members are themselves registered securities dealers.

A transaction's status as an SLA is relevant to, among other things, the tax treatment of amounts paid and received in compensation for dividends or interest on the security that is transferred or lent. New subsections 260(11) and (12) are added to ensure the appropriate treatment of these amounts in a case where a corporation or an individual is a member of a partnership that has entered into an SLA.

- Under new paragraph 260(11)(*a*), a corporation that is a member of a partnership is treated for the purpose of subsection 260(5) as having received its "specified proportion" (now defined in subsection 248(1) of the Act) of each compensation payment or amount in respect of proceeds of disposition that is described in subsection 260(5) and was received by the partnership. It is also treated as being the same person as the partnership, thus ensuring that the partnership's reasons for entering into the arrangement (which are relevant to the applicability of the subsection) are attributed to the corporation.

- New paragraph 260(11)(*b*) treats the corporation as being obligated to pay its specified proportion of each dividend compensation payment described in paragraph 260(6.1)(*a*).

- New paragraph 260(11)(*c*) treats the corporation, for the purpose of applying the dividend refund rules in section 129 of the Act, as

having paid its specified proportion of each non-deductible dividend compensation payment made by the partnership.

- New paragraph 260(12)(*a*) performs for individuals who are members of a partnership the same functions as new paragraph 260(11)(*a*) does for corporations that are partners.

- New paragraph 260(12)(*b*) treats an individual partner as having paid, for the purpose of clause 82(1)(*a*)(ii)(B) of the Act, the individual's specified proportion of each dividend compensation payment paid by the partnership that is deemed by new subsection 260(5.1) to have been received by another person as a taxable dividend.

These amendments apply to SLAs made after December 20, 2002 and, if the parties jointly elect within 90 days after this Act has been assented to, they also apply to SLAs made after November 2, 1998 and on or before December 20, 2002, except that before 2002, the reference to "subsection 260(5.1)" should be read as "subsection 260(5)".

# PART II

# FOREIGN AFFILIATES

## Clause 128

### Amount Owing by Non-resident

ITA
17

Section 17 of the *Income Tax Act* provides rules dealing with the situation where a non-resident person owes an amount to a corporation resident in Canada. Subsection 17(1) generally applies where such an amount has remained outstanding for more than one year without the corporation including interest on that amount, computed at a reasonable rate, in computing its income. Where subsection 17(1) applies, it treats the corporation resident in Canada as having received interest on that amount, computed at a prescribed rate, at the end of each taxation year of the corporation during which that amount was outstanding.

### Borrowed Money

ITA
17(8.1) and (8.2)

Subsection 17(8) of the Act provides an exception to subsection 17(1) with respect to amounts owing by a non-resident person to a particular corporation resident in Canada where

- the non-resident person is a controlled foreign affiliate of the particular corporation, and
- the amount owing meets the test set out in either subparagraph 17(8)(*a*)(i) or (ii).

However, the exception afforded by subsection 17(8) is not available in circumstances where the amount owing by the controlled foreign affiliate is incurred to pay existing indebtedness of the affiliate to another person or partnership (other than the particular corporation) because the amount owing arose for the purpose of allowing the affiliate to pay the existing indebtedness rather than for a use that qualifies under subparagraph 17(8)(*a*)(i) or (ii). New subsections 17(8.1) and (8.2) are introduced to address this issue.

New subsection 17(8.1) provides that new subsection 17(8.2) applies in respect of money (referred to as "new borrowings") that a

controlled foreign affiliate of a particular corporation resident in Canada has borrowed from the particular corporation where the affiliate has used the new borrowings

- to repay money (referred to as "previous borrowings") previously borrowed from any person or partnership, if
  - the previous borrowings became owing after the last time that the affiliate became a controlled foreign affiliate of the particular corporation, and
  - the previous borrowings have, at all times after they became owing, been used for a purpose described in subparagraph 17(8)(*a*)(i) or (ii), or
- to pay an amount owing (referred to as the "unpaid purchase price") by the affiliate for property previously acquired from any person or partnership, if
  - the property was acquired, and the unpaid purchase price became owing, by the affiliate after the last time that the affiliate became a controlled foreign affiliate of the particular corporation,
  - the unpaid purchase price is in respect of the property, and
  - throughout the period that began when the unpaid purchase price became owing by the affiliate and ended when the unpaid purchase price was so paid, the property had been used principally to earn income described in clause 17(8)(*a*)(i)(A) or (B).

New subsection 17(8.2) provides that the new borrowings are, for the purpose of subsection 17(8), deemed to have been used for the purpose for which the proceeds from the previous borrowings were used or were deemed by subsection 17(8.2) to have been used, or to acquire the property in respect of which the unpaid purchase price was payable, as the case may be.

New subsections 17(8.1) and (8.2) apply to taxation years that begin after February 23, 1998.

**Definition "controlled foreign affiliate"**

ITA
17(15)

Subsection 17(15) of the Act contains definitions that apply to section 17. That subsection is amended by replacing the definition "controlled foreign affiliate" in subsection 17(15) to provide that "controlled foreign affiliate", at any time, of a taxpayer resident in Canada, means a corporation that would, at that time, be a controlled foreign affiliate of the taxpayer within the meaning assigned by the definition "controlled foreign affiliate" in subsection 95(1) if

- that definition were read without reference to its paragraph (*a*);

- subparagraph (*c*)(ii) of that definition read as follows:

  "(ii) each person resident in Canada that does not deal at arm's length with the taxpayer,"; and

  - subparagraph (*c*)(iv) of that definition read as follows:

    "(iv) each person resident in Canada that does not deal at arm's length with a person resident in Canada described in subparagraph (iii);".

These amendments to the definition "controlled foreign affiliate" in section 17 are consequential to the proposed new amendments to the definition "controlled foreign affiliate" in subsection 95(1). See the commentary for subsection 95(1) for details about the amendments to the definition "controlled foreign affiliate" in subsection 95(1).

This amended definition "controlled foreign affiliate" in subsection 17(15) applies to taxation years of a foreign affiliate of a taxpayer that begin after February 23, 1998. However, the following transitional rules apply for taxation years that begin after February 23, 1998 and on or before Announcement Date:

• for taxation years of a foreign affiliate of a taxpayer that begin after 2002 and on or before Announcement Date, that definition is to be read as follows:

  "controlled foreign affiliate" has the meaning that would be assigned by the definition "controlled foreign affiliate" in subsection 95(1) if

  - that definition were without reference to its paragraph (*a*); and

- subparagraph (*c*)(iii) of that definition were read as follows:

  "(iii) the taxpayer and each person resident in Canada with whom the taxpayer does not deal at arm's length;" and

- for taxation years of a foreign affiliate of a taxpayer that begin after February 23, 1998 and before 2003, that definition is to be read as follows:

  "controlled foreign affiliate" has the meaning that would be assigned by the definition "controlled foreign affiliate" in subsection 95(1) if subparagraph (*b*)(iii) of that definition were read as follows:

  "(iii) the taxpayer and each person resident in Canada with whom the taxpayer does not deal at arm's length".

**Clause 129**

**Consideration for Warranties, Covenants or Other Obligations**

ITA
42

Section 42 of the Act provides rules governing warranties, covenants, and other conditional or contingent obligations given by a taxpayer in respect of a disposition of properties.

Section 42 is amended to provide that an amount received or receivable by a taxpayer in a taxation year as consideration for a warranty, a covenant or another conditional or contingent obligation given or incurred by the taxpayer in respect of a property disposed of, at any time, by the taxpayer

- is, if the amount is received or becomes receivable on or before the taxpayer's filing-due date for the taxpayer's taxation year in which the taxpayer disposed of the property, to be included in computing the taxpayer's proceeds of disposition of the property, and

- is, if the amount is received or becomes receivable after that filing-due date, deemed to be a capital gain of the taxpayer from the disposition, by the taxpayer of the property, that occurs at the time when the amount is received or becomes receivable.

This section is also amended to provide that an outlay or expense paid or payable by the taxpayer in a taxation year under a warranty, covenant or another conditional or contingent obligation given or

incurred by the taxpayer in respect of property disposed of, at any time, by the taxpayer

- is, if the amount is paid or becomes payable on or before the taxpayer's filing-due date for the taxpayer's taxation year in which the taxpayer disposed of the property, to be deducted in computing the taxpayer's proceeds of disposition of the property, and

- is, if the amount is paid or becomes payable after that filing-due date, deemed to be a capital loss of the taxpayer from the disposition, by the taxpayer of the property, that occurs at the time when the amount is paid or becomes payable.

This change applies to taxation years that end after Announcement Date.

**Clause 130**

**Winding-up of a Corporation**

ITA
88(1)(*d*.4)

Subsection 88(1) of the Act provides rules that apply where a subsidiary has been wound up into its parent corporation where both corporations are taxable Canadian corporations and the parent owns at least 90% of the issued shares of each class of the capital stock of the subsidiary.

Subsection 88(1) is amended by adding proposed new paragraph (*d*.4) effective for amalgamations that occur after Announcement Date and to windings-up that begin after Announcement Date. Taxpayers may elect to have the provision apply to all amalgamations that occur, and all windings-up that begin, after December 20, 2002.

In general terms, proposed new paragraph 88(1)(*d*.4) applies for the purpose of subparagraph 88(1)(*d*)(ii) and increases, in certain circumstances, the cost amount to the subsidiary of a share of a foreign affiliate of the subsidiary or the cost amount of a partnership interest in a partnership that holds such a share, thereby limiting the amount of a increase in cost base of a property to the parent that is the share or the interest in the partnership that might otherwise occur on an amalgamation or a winding up of the subsidiary.

New paragraph 88(1)(*d*.4) provides that

- if, at the time immediately before the winding-up, the subsidiary holds one or more shares of a foreign affiliate of the subsidiary, there shall be added to the cost amount, at that time, of each of those shares (referred to here as the "particular share") the amount determined by the formula

$$\frac{A \times B}{C}$$

where

A is the total of all amounts each of which is the amount, if any, by which

(A) the amount of a dividend received on any share of the foreign affiliate (or any other share of the foreign affiliate for which that share is substituted property) held by the subsidiary immediately before the winding-up, that was deductible under section 113 in computing the income of the subsidiary or of a corporation with which the subsidiary was not dealing at arm's length (otherwise than because of a right referred to in paragraph 251(5)(*b*) in respect of the foreign affiliate),

exceeds

(B) the portion of that dividend that may reasonably be considered to have reduced the foreign affiliate's exempt or taxable surplus in respect of the subsidiary that arose after the acquisition of control of the subsidiary by the parent (determined on the assumption that a dividend is paid out of the foreign affiliate's exempt or taxable surplus, as the case may be, in respect of the subsidiary, in the reverse order to that in which it was added to the foreign affiliate's exempt or taxable surplus in respect of the subsidiary),

B is the fair market value of the particular share immediately before the winding-up, and

C is the total of all amounts each of which is the fair market value of a share of the foreign affiliate held by the subsidiary immediately before the winding-up, and

- if, at the time immediately before the winding-up, the subsidiary holds a partnership interest in a partnership

(a "holding partnership") which holds one or more shares of a foreign affiliate of the subsidiary, there shall be added to the cost amount, at that time, of the subsidiary's partnership interest in the holding partnership (referred to as the "particular partnership interest"), the amount determined by the formula

$$\frac{D \times E}{F}$$

where

D is the total of all amounts each of which is the amount, if any, by which

(A) the amount of a dividend received on any share of the foreign affiliate (or any other share of the foreign affiliate for which that share is substituted property) held by a holding partnership immediately before the winding-up, that was deductible under section 113 in computing the income of the subsidiary or of a corporation with which the subsidiary was not dealing at arm's length (otherwise than because of a right referred to in paragraph 251(5)(*b*) in respect of the foreign affiliate),

exceeds

(B) the portion of that dividend that may reasonably be considered to have reduced the foreign affiliate's exempt or taxable surplus in respect of the subsidiary that arose after the acquisition of control of the subsidiary by the parent (determined on the assumption that a dividend is paid out of the foreign affiliate's exempt or taxable surplus, as the case may be, in respect of the subsidiary, in the reverse order to that in which it was added to the foreign affiliate's exempt or taxable surplus in respect of the subsidiary),

E is the fair market value of the particular partnership interest immediately before the winding-up, and

F is the total of all amounts each of which is the fair market value of a partnership interest in a holding partnership held by the subsidiary immediately before the winding-up.

## Distributions of Property of a Foreign Affiliate

ITA
88(3)

Subsection 88(3) of the Act provides for rules that apply on the dissolution of a controlled foreign affiliate (a “disposing affiliate”) of a taxpayer resident in Canada. For example, shares of a foreign affiliate of a taxpayer that are transferred to the taxpayer on the dissolution of the disposing affiliate will be considered to have been disposed of by the controlled foreign affiliate, and to have been acquired by the taxpayer, for the adjusted cost base or such greater amount as the taxpayer claims not exceeding the fair market value of the shares. Also, in general terms, the taxpayer’s proceeds of disposition of the taxpayer’s shares of the capital stock of the controlled foreign affiliate disposed of on the dissolution are deemed to be the amount, if any, by which the total of all amounts each of which is the cost to the taxpayer of property received by the taxpayer from the controlled foreign affiliate on the dissolution exceeds the total of all debts of the controlled foreign affiliate that were assumed or cancelled by the taxpayer on the dissolution.

In general terms, subsection 88(3) is being amended to be applicable to property received, by a taxpayer resident in Canada from a foreign affiliate of a taxpayer resident in Canada, in the following circumstances:

- on a dissolution and liquidation of the foreign affiliate,
- on a redemption of shares by the foreign affiliate,
- as payment of a dividend by the foreign affiliate, or
- as a distribution of property by the foreign affiliate.

This amendment applies to property received after Announcement Date.

Proposed subsection 88(3) provides for the following rules if, at any time (referred to in this commentary as the “distribution time”), a taxpayer resident in Canada receives, in the circumstances described above, a property from a foreign affiliate of the taxpayer (the property received and the foreign affiliate from which the property was received being referred to in this subsection as the “distributed property” and the “disposing foreign affiliate”, respectively):

- If the distributed property was, immediately before the distribution time, a share of the capital stock of another foreign affiliate of the taxpayer and an excluded property of the disposing foreign affiliate,

  - the distributed property is deemed to have been disposed of, at the distribution time, by the disposing foreign affiliate to the taxpayer for proceeds of disposition that are equal to

    - unless a valid election referred to below is made, the adjusted cost base to the disposing foreign affiliate of the distributed property, immediately before that time, and

    - the amount that the taxpayer elects in the prescribed manner and in the prescribed time (see proposed new section 5919 of the *Income Tax Regulations*) in respect of the distributed property, which amount may not be less than the adjusted cost base to the disposing foreign affiliate of the distributed property immediately before that time and may not exceed the fair market value, at that time, of the distributed property, and

  - the distributed property is deemed to have been acquired, at that time, by the taxpayer at a cost equal to the amount determined to be the disposing foreign affiliate's proceeds of disposition of the distributed property.

- If the distributed property is not, immediately before the distribution time, both a share of the capital stock of another foreign affiliate of the taxpayer and an excluded property of the disposing foreign affiliate,

  - the distributed property is deemed to have been disposed of, at that time, by the disposing foreign affiliate to the taxpayer for proceeds of disposition that are equal to the fair market value, at that time, of the distributed property, and

  - the distributed property is deemed to have been acquired, at that time, by the taxpayer at a cost equal to the amount determined to be the disposing foreign affiliate's proceeds of disposition of the distributed property.

- If the taxpayer disposed of shares of the capital stock of the disposing foreign affiliate on the dissolution and liquidation of the disposing foreign affiliate or on the redemption, acquisition or cancellation of shares of the disposing foreign affiliate, as the case

may be, the taxpayer's proceeds of disposition of the shares are deemed to be the amount determined by the formula

$$A - B$$

where

A is the total of all amounts each of which is the cost to the taxpayer of a distributed property received by the taxpayer as consideration for the disposition of the shares, and

B is the total of all amounts each of which is the amount of a debt owing by the disposing foreign affiliate or of an obligation of the disposing foreign affiliate to pay an amount (other than a dividend payable to the taxpayer or to persons with whom the taxpayer does not deal at arm's length) that was assumed or cancelled by the taxpayer because of the dissolution and liquidation or because of the redemption, acquisition or cancellation.

- If the taxpayer has received distributed property as a dividend or a distribution of property, the amount of the dividend paid by the disposing foreign affiliate or the amount of the distribution of property made by the disposing foreign affiliate to the taxpayer, as case may be, is deemed to be the amount determined by the formula

$$D - E$$

where

D is the total of all amounts each of which is the cost to the taxpayer of a distributed property received by the taxpayer from the disposing foreign affiliate as the payment of a dividend or as the distribution of property, as the case may be, and

E is the total of all amounts each of which is the amount of a debt owing by the disposing foreign affiliate or of an obligation of the disposing foreign affiliate to pay an amount (other than a dividend payable to the taxpayer or to persons with whom the taxpayer does not deal at arm's length) that was assumed or cancelled by the taxpayer because of the payment of the dividend or because of the distribution.

- The amount of a distribution of property made, at the distribution time, by the disposing foreign affiliate to the taxpayer, is to be deducted in computing the taxpayer's adjusted cost base of a particular share of the capital stock of the disposing foreign affiliate held by the taxpayer, at that time, to the extent that it is

reasonable to consider the distribution as a payment made by the disposing foreign affiliate to the taxpayer as

- a return of an amount that was received by the disposing foreign affiliate as consideration for the issuance of the particular share, or

- a return of an amount of contributed surplus that was received by the disposing foreign affiliate, before the distribution time, as a contribution of capital to the disposing foreign affiliate by the shareholder that held the particular share at that time of the contribution.

• The amount of a distribution of property made, at the distribution time, by the disposing foreign affiliate to the taxpayer is to be included in computing the taxpayer's income as income from property that is the shares of the capital stock of disposing foreign affiliate held at that time by the taxpayer, to the extent that it is not deducted in computing the adjusted cost base of a particular share of the capital stock of the disposing foreign affiliate held by the taxpayer.

**Clause 131**

**Adjusted Cost Base of Share of Foreign Affiliate**

ITA
92

Section 92 of the Act provides for adjustments to be made to the adjusted cost base of a share in a foreign affiliate of a taxpayer resident in Canada.

**Where Subsection 92(1.3) Applies**

ITA
92(1.1)

New subsection 92(1.1) of the Act provides that new subsection 92(1.3) of the Act will apply to the holder of a share of a foreign affiliate of a corporation resident in Canada in computing at any time the adjusted cost base of the share if there is a "specified section 93 election" related to the share. Subsection 92(1.1) defines that share as the "relevant share", and defines such a time as the "computation time", for the purposes of subsections 92(1.2) and (1.3). Also, subsection 92(1.1) defines that foreign affiliate as the "relevant foreign affiliate", for the purpose of subsection 92(1.2).

For information regarding the coming-into-force of this subsection, refer to the commentary regarding new subsection 92(1.4).

**Specified Section 93 Election**

ITA
92(1.2)

New subsection 92(1.2) of the Act establishes, for the purposes of subsections 92(1.1) and (1.3), whether an election made under subsection 93(1) or (1.2) by a particular corporation resident in Canada in respect of a share of a particular foreign affiliate of the particular corporation that is disposed of at a time before the computation time is, at the computation time, a "specified section 93 election" related to the relevant share. The time of that disposition is referred to in subsection 92(1.2) as the "election time".

Such an election is, at the computation time, a "specified section 93 election" related to the relevant share for the purposes of subsections 92(1.1) and (1.3) if

- the particular foreign affiliate has, at the election time, an equity percentage in the relevant foreign affiliate;
- the relevant foreign affiliate was, at the election time, a foreign affiliate of the particular corporation;
- throughout the period that begins at the election time and ends at the computation time;
  - the holder held the relevant share, and
  - the holder was
    - a foreign affiliate of the particular corporation,
    - a foreign affiliate of a corporation resident in Canada that was related to the particular corporation,
    - a partnership of which a foreign affiliate of the particular corporation was a member, or
    - a partnership of which a foreign affiliate, of a corporation resident in Canada that was related to the particular corporation, was a member;
- the relevant share was, at the election time, excluded property of the holder (or would at that time have been excluded property of

the holder if the holder had been a foreign affiliate of the particular corporation); and

- the relevant share is, at the computation time, excluded property of the holder (or would at that time have been excluded property of the holder if the holder had been a foreign affiliate of the particular corporation or of a corporation resident in Canada that is related to the particular corporation).

For information regarding the coming-into-force of this subsection, refer to the commentary regarding new subsection 92(1.4).

**Adjustments to Adjusted Cost Base**

ITA
92(1.3)

New subsection 92(1.3) of the Act contains rules that require adjustments to the adjusted cost base to the holder of the "relevant share". See the commentary to new subsection 92(1.1) for information regarding the circumstances that make subsection 92(1.3) apply. The adjustments are for the purposes described in subsection 92(1.4).

Under the rules contained in subsection 92(1.3), there is to be added to, or deducted from, as the case may be, the adjusted cost base to the holder of the relevant share the amount prescribed in new section 5911 of the *Income Tax Regulations* in respect of the specified section 93 election related to the relevant share.

For information regarding the coming-into-force of this subsection, refer to the commentary regarding new subsection 92(1.4).

**Applicability of Subsection 92(1.3)**

ITA
92(1.4)

New subsection 92(1.4) of the Act sets out the purposes for which the adjustments described in new subsection 92(1.3) are applicable.

Those purposes are

- the computation of the exempt surplus or deficit, the taxable surplus or deficit, and the underlying foreign tax, of the holder, in respect of the corporation resident in Canada, or in respect of any other person referred to in subparagraphs 95(2)(*f*)(iv) to (vii) on the

assumption that the taxpayer referred to in those subparagraphs were the particular corporation resident in Canada, and

- the application of paragraphs 95(2)(*c*.1) to (*e*.6), at any time after the time of the election.

**Coming-into-Force**

New subsections 92(1.1) to (1.4) apply in respect of elections made under subsection 93(1) or (1.2) in respect of dispositions that occur after December 20, 2002.

However, new subsections 92(1.1) to (1.4) will not apply in respect of elections made under subsection 93(1) or (1.2) in respect of a disposition by a vendor of a share if one of the following conditions are met:

- the disposition was required to be made under an agreement in writing made by the vendor on or before December 20, 2002,

- the disposition occurs on or before Announcement Date and either

    - a valid election was made by the taxpayer to have new paragraphs 95(2)(*c*.1) to (*c*.6) of the Act not apply (and to have a modified version of the draft paragraphs 93(1.4) to (1.6) of the Act that were announced on December 20, 2002 apply) to dispositions made after December 20, 2002 and on or before Announcement Date, or

    - none of new paragraphs 88(3)(*a*), 95(2)(*c*.2) and 95(2)(*d*) to (*e*.5) of the Act applies to the disposition, or

- the disposition occurs after Announcement Date and that disposition is required to be made under an agreement in writing made by the vendor on or before Announcement Date, and none of paragraphs 88(3)(*a*), 95(2)(*c*.2) and 95(2)(*d*) to (*e*.5) of the Act applies to the disposition.

For information about the aforementioned election and the aforementioned modified version of subsections 93(1.4) to (1.6), refer to the commentary to new paragraphs 95(2)(*c*.1) to (*c*.6).

**Clause 132**

**Disposition of Shares of Foreign Affiliate**

ITA
93

Section 93 of the Act contains a number of rules relating to the disposition of shares of the capital stock of a foreign affiliate of a corporation resident in Canada.

**Election re Disposition of Share in Foreign Affiliate**

ITA
93(1)

Subsection 93(1) of the Act permits a corporation resident in Canada that disposes of a share of a foreign affiliate of the corporation to elect to receive the proceeds of disposition of the share as a dividend on the share rather than as proceeds of disposition of the share.

ITA
93(1)(*a*)

Paragraph 93(1)(*a*) of the Act provides that the amount elected in respect of the proceeds of disposition cannot exceed the proceeds of disposition of the share otherwise determined and that the amount elected is deemed to be a dividend received on the share and is deemed not to be proceeds of disposition. The amendments to subparagraph 93(1)(*a*) provide that the amount elected in respect of the proceeds of disposition of the share cannot exceed those proceeds of disposition otherwise determined, nor exceed the amount prescribed, under proposed new subsection 5902(6) of the Regulations, in respect of the share being disposed of.

Refer to the coming-into-force commentary below to determine the coming-into-force dates for these amendments.

**Deemed Election**

ITA
93(1.1)

Subsection 93(1.1) of the Act provides that the rules in subsection 93(1) will automatically apply in respect of a disposition of a share of a foreign affiliate of a corporation resident in Canada by another foreign affiliate of the corporation, without the need for an election, where the share disposed of was "excluded property" (as defined in

subsection 95(1)) of the vendor (other than a disposition, of a share that is excluded property, to which paragraph 95(2)(*c*), (*d*) or (*e*) applies). The amount of the deemed election in respect of the proceeds of disposition of the share is determined by the Regulations but will not in any event exceed the vendor's capital gain otherwise determined in respect of the disposition.

Subsection 93(1.1) is amended

- to remove the requirement that the shares be excluded property of the foreign affiliate of the corporation resident in Canada that disposed of the share, and

- to remove the rule that made the deemed election apply in respect of a disposition, of a share that is an excluded property, to which paragraph 95(2)(*c*), (*d*) or (*e*) applies. (Such a rule is no longer needed, as the excluded property requirement has been removed altogether.)

Refer to the coming-into-force commentary below to determine the coming-into-force dates for these amendments

**Disposition of a Share of a Foreign Affiliate Held by a Partnership**

ITA
93(1.2)

Subsection 93(1.2) of the Act provides that, where a particular corporation resident in Canada or a foreign affiliate of the particular corporation (each of which is referred to as the "disposing corporation") would, but for that subsection, have a taxable capital gain from a disposition by the partnership of a particular share of a class of the capital stock of a foreign affiliate of the corporation, and the disposing corporation elects in prescribed manner in respect of the gain, the amount designated in the election will reduce the taxable capital gain and will be grossed-up and treated as a dividend received on the particular share by the disposing corporation.

Subsection 93(1.2) is being amended in the following ways:

- The preamble of that section is amended to add a requirement that the election in respect of the disposition be filed "within the prescribed time".

- Subparagraph (*a*)(i) of that section is amended to provide that the amount designated by the corporation in the election cannot exceed the lesser of two amounts.

- The first amount is the amount determined by the following formula

  $$K \times L/M$$

  where

  K is the taxable capital gain of the partnership,

  L is the number of shares of that class of the capital stock of the foreign affiliate, determined as the amount, if any, by which the number of those shares that were deemed to have been owned by the disposing corporation for the purposes of subsection 93.1(1) immediately before the disposition exceeds the number of those shares that were deemed to have been owned for those purposes by the disposing corporation immediately after the disposition, and

  M is the number of those shares of the foreign affiliate that were owned by the partnership immediately before the disposition; and

- the second amount is the amount prescribed in respect of the share (see new Regulation 5902(7)).

Refer to the coming-into-force commentary below to determine the coming-into-force dates for these amendments.

**No Election**

ITA
93(1.4)

New subsection 93(1.4) of the Act provides that, notwithstanding subsections 93(1) to (1.3), no election may be made under subsection 93(1) or (1.2) by a corporation in respect of a disposition of a share of the capital stock of a foreign affiliate of the corporation if any of paragraph 88(3)(*a*) and subparagraphs 95(2)(*d*)(i), (*d*.1)(i), (*e*)(i), (*e*.1)(i), (*e*.2)(i), (*e*.3)(i), (*e*.4)(i) and (*e*.5)(i) applies to the disposition.

Refer to the coming-into-force commentary below to determine the coming-into-force dates for this new subsection.

**Coming-into-Force (ITA 93(1)(*a*), 93(1.1), 93(1.2), (1.3) and (1.4))**

The amendments to paragraph 93(1)(*a*), to subsection 93(1.1) and to subparagraph 93(1.2)(*a*)(i) apply to dispositions that occur after December 20, 2002.

However, those amendments will not apply in respect of dispositions by a vendor if one of the following conditions are met:

- the disposition is required to be made under an agreement in writing made by the vendor on or before December 20, 2002,

  - the disposition occurs on or before Announcement Date and either

  - a valid election was made by the taxpayer to have new paragraphs 95(2)(*c*.1) to (*c*.6) of the Act not apply (and to have a modified version of the draft paragraphs 93(1.4) to (1.6) of the Act that were announced on December 20, 2002 apply) to dispositions made after December 20, 2002 and on or before Announcement Date, or

  - none of new paragraphs 88(3)(*a*), 95(2)(*c*.2), and 95(2)(*d*) to (*e*.5) of the Act applies to the disposition, or

  - the disposition occurs after Announcement Date, that disposition is required to be made under an agreement in writing made by the vendor on or before Announcement Date and none of new paragraphs 88(3)(*a*), 95(2)(*c*.2) and 95(2)(*d*) to (*e*.5) of the Act applies to the disposition.

For information about the aforementioned election and the aforementioned modified version of subsections 93(1.4) to (1.6), refer to the commentary to new paragraphs 95(2)(*c*.1) to (*c*.6).

The amendment to the preamble of subsection 93(1.2) applies to dispositions that occur after November 1999.

New subsection 93(1.4) applies to dispositions that occur after Announcement Date.

**Loss Limitation on Disposition of Share**

ITA
93(2)

Subsection 93(2) of the Act provides rules for the purpose of determining the loss of a corporation resident in Canada from the disposition of a share of a foreign affiliate of the corporation or the loss of a foreign affiliate of the corporation from a disposition of a share of the capital stock of another foreign affiliate of the corporation that is not excluded property to the foreign affiliate that disposed of the share.

The amount of the loss, determined without reference to this subsection, is reduced by exempt dividends received, on the share or a share for which the share was substituted, by the corporation resident in Canada, by another corporation resident in Canada that is related to the corporation or by a foreign affiliate of either of those corporations resident in Canada (to the extent that the exempt dividends have not already reduced losses or allowable capital losses of those corporations or foreign affiliates under subsection 93(2), (2.1), (2.2) or (2.3) of the Act). The term "exempt dividend" is defined in subsection 93(3) of the Act.

Subsection 93(2) of the Act is being amended to permit the corporation resident in Canada or its foreign affiliate to restore a loss from a disposition of a share of the capital stock of a foreign affiliate of the corporation resident in Canada to the extent of the lesser of two amounts.

- The first amount is the reduction of that loss which is attributable to exempt dividends.

- The second amount is the total of the following gains determined in respect of the corporation resident in Canada or the foreign affiliate, as the case may be, that disposed of the share:

  - The foreign exchange gain arising on the settlement or extinguishment of an obligation issued or incurred to acquire the share.

  - The foreign exchange gain arising on the redemption, acquisition or cancellation of shares issued to acquire the share.

    - The gain arising under an agreement that provides for the purchase, sale or exchange of a currency, or from the disposition of a currency, that was entered into or acquired for hedging the foreign exchange exposure arising in connection with the acquisition of the share.

First, the formula in subsection 93(2) is amended by adding the new variable "D" and will read as follows:

$$A - (B - C) \underline{+ D}$$

Second, the addition to the loss under new variable "D" will be determined as the lesser of

- The reduction of the loss in respect of exempt dividends (determined as (B - C) in the formula), and

- The total of the following amounts determined in respect of the corporation resident in Canada or the foreign affiliate of the corporation resident in Canada, as the case may be:

  - the amount of the capital gain determined under paragraph 39(2)(*a*) for the taxation year that includes that time in respect of

    - the settlement or extinguishment of an obligation of the corporation resident in Canada or of the foreign affiliate of the corporation resident in Canada, as the case may be, that can reasonably be considered to have been issued or incurred in relation to the acquisition of the affiliate share by the corporation resident in Canada or by the foreign affiliate of the corporation resident in Canada, as the case may be, or

    - the redemption, acquisition or cancellation of a share of the capital stock of a corporation resident in Canada or of the foreign affiliate of the corporation resident in Canada, as the case may be, that can reasonably be considered to have been issued in relation to the acquisition of the affiliate share by the corporation resident in Canada or by the foreign affiliate of the corporation resident in Canada, as the case may be, and

  - the amount of any gain realized by the corporation resident in Canada or by the foreign affiliate of the corporation resident in Canada, as the case may be, under an agreement that provides for the purchase, sale or exchange of currency, or from the disposition of a currency, which agreement or currency, as the case may be, can reasonably be considered to have been entered into or acquired, by the corporation resident in Canada or by the foreign affiliate resident in Canada, as the case may be, for the principal purpose of hedging the foreign exchange exposure arising in connection with the acquisition of the affiliate share.

Refer to the coming-into-force commentary below to determine the coming-into-force for this new subsection.

**Loss Limitation - Disposition of Partnership Interest**

ITA
93(2.1)

Subsection 93(2.1) of the Act provides rules for the purpose of determining the allowable capital loss of a corporation resident in Canada from the disposition by a partnership of a share of the capital stock of a foreign affiliate of the corporation and for the purpose of

determining the allowable capital loss of a foreign affiliate of a corporation resident in Canada from a disposition by a partnership of a share of the capital stock of another foreign affiliate of the corporation that would not be excluded property of the foreign affiliate if the foreign affiliate owned the share immediately before it was disposed of.

The amount of the allowable capital loss otherwise determined is reduced by ½ of the exempt dividends received, on the share or a share for which the share was substituted, by the corporation resident in Canada, by another corporation resident in Canada that is related to the corporation resident in Canada, or by a foreign affiliate of either of those corporations resident in Canada (to the extent that the exempt dividends have not already reduced losses or allowable capital losses of those corporations or foreign affiliates under subsection 93(2), (2.1), (2.2) or (2.3) of the Act). The term "exempt dividend" is defined in subsection 93(3) of the Act.

Subsection 93(2.1) is being amended to permit the corporation resident in Canada or its foreign affiliate to restore an allowable capital loss from a disposition by a partnership of a share of the capital stock of a foreign affiliate of the corporation resident in Canada to the extent of the lesser of two amounts.

The addition to the loss under new variable "D" will be determined as the lesser of

- The first amount is the reduction of that allowable capital loss which is attributable to exempt dividends.

- The second amount is ½ of the total of the following gains determined in respect of the corporation resident in Canada or the foreign affiliate, as the case may be,

    - The foreign exchange gain arising on the settlement of an obligation issued or incurred to acquire the share.

    - The foreign exchange gain arising on the redemption, acquisition or cancellation of shares issued to acquire the share.

        - The gain arising under an agreement that provides for the purchase, sale or exchange of a currency, or from the disposition of a currency, that was entered into or acquired for hedging the foreign exchange exposure arising in connection with the acquisition of the share.

First, the formula in subsection 93(2.1) is amended by adding the new variable "D" and will read as follows:

A - (B - C) <u>+ D</u>

Second, the addition to the allowable capital loss under new variable "D" will be determined as the lesser of:

- The reduction of the allowable capital loss in respect of exempt dividends (determined as (B - C) in the formula), and

- ½ of the total of the following amounts determined in respect of the corporation resident in Canada or the foreign affiliate of the corporation resident in Canada, as the case may be,

    - the amount of the capital gain of the corporation resident in Canada, of the foreign affiliate of the corporation resident in Canada, or of the partnership (to the extent that such a gain is reasonably attributable to the corporation resident in Canada, or to the foreign affiliate of the corporation resident in Canada, as the case may be) determined under paragraph 39(2)(*a*) for the taxation year that includes that time in respect of

        - the settlement or extinguishment of an obligation of the corporation resident in Canada, of the foreign affiliate of the corporation resident in Canada, or of the partnership, as the case may be, that can reasonably be considered to have been issued or incurred in relation to the acquisition of the affiliate share by the partnership, or

        - the redemption, acquisition or cancellation of a share of the capital stock of a corporation resident in Canada or of the foreign affiliate of the corporation resident in Canada, as the case may be, that can reasonably be considered to have been issued in relation to the acquisition of the affiliate share by the partnership, and

    - the amount of any gain realized by the partnership (to the extent that the gain is reasonably attributable to the corporation resident in Canada or to the foreign affiliate of the corporation resident in Canada, as the case may be), by the corporation resident in Canada or by the foreign affiliate of the corporation resident in Canada, as the case may be, under an agreement that provides for the purchase, sale or exchange of currency, or from the disposition of a currency, which agreement or currency, as the case may be, can reasonably be considered to have been entered into or acquired, by the partnership, by the corporation resident in Canada or by the foreign affiliate of the corporation resident in Canada, as the case may be, for the principal purpose of

hedging the foreign exchange exposure arising in connection with the acquisition of the affiliate share.

Refer to the coming-into-force commentary below to determine the coming-into-force for this new subsection.

**Loss Limitation - Disposition of Partnership Interest**

ITA
93(2.2)

Subsection 93(2.2) of the Act provides rules for the purpose of determining the loss of a corporation resident in Canada from the disposition of an interest in a partnership that holds interests in shares of the capital stock of a foreign affiliate of the corporation resident in Canada or the loss of a foreign affiliate of the corporation from a disposition of an interest in a partnership that holds interests in shares of the capital stock of another foreign affiliate of the corporation that would not be excluded property of the foreign affiliate if the foreign affiliate owned the share immediately before it was disposed of.

The amount of the loss otherwise determined is reduced by exempt dividends received on the shares, or shares for which the shares were substituted, by the corporation resident in Canada, by another corporation resident in Canada that is related to the corporation, or a by foreign affiliate of either of those corporations resident in Canada (to the extent that the exempt dividends have not already reduced losses or allowable capital losses of those corporations or foreign affiliates under subsection 93(2), (2.1), (2.2) or (2.3) of the Act). The term "exempt dividend" is defined in subsection 93(3) of the Act.

Subsection 93(2.2) is being amended to permit the corporation resident in Canada or its foreign affiliate to restore a loss arising on the disposition of an interest in a partnership that holds interests in shares of the capital stock of a foreign affiliate of the corporation resident in Canada to the extent of the lesser of two amounts.

- The first amount is the reduction of the loss attributable to exempt dividends.
- The second amount is the sum of the following gains determined in respect of the corporation or the foreign affiliate, as the case may be, that disposed of the partnership interest
  - The foreign exchange gain arising on the settlement of an obligation issued or incurred to acquire the share interests held by the partnership.

- The foreign exchange gain arising on the redemption, acquisition or cancellation of shares issued to acquire share interests held by the partnership.

- The gain arising under an agreement that provides for the purchase, sale or exchange of a currency, or from the disposition of a currency, that was entered into or acquired for hedging the foreign exchange exposure arising in connection with the acquisition of the share interests held by the partnership.

First, the formula in subsection 93(2.2) is being amended by adding the new variable "D" and will read as follows:

$$A - (B - C) \underline{+ D}$$

Second, the addition to the loss under new variable "D" will be determined as the lesser of

- The reduction of the loss in respect of exempt dividends (determined as (B - C) in the formula), and

- The total of the following amounts determined in respect of the corporation resident in Canada or the foreign affiliate of the corporation resident in Canada, as the case may be,

    - the amount of the capital gain of the corporation resident in Canada, of the foreign affiliate of the corporation resident in Canada, or of the partnership (to the extent that such a gain is reasonably attributable to the corporation resident in Canada, or to the foreign affiliate of the corporation resident in Canada, as the case may be) determined under paragraph 39(2)(*a*) for the taxation year that includes that time in respect of

        - the settlement or extinguishment of an obligation of the corporation resident in Canada, of the foreign affiliate of the corporation resident in Canada, or of the partnership, as the case may be, that can reasonably be considered to have been issued or incurred in relation to the acquisition of the affiliate shares, or

        - the redemption, acquisition or cancellation of a share of the corporation resident in Canada or of the foreign affiliate resident in Canada, as the case may be, or of an interest in the partnership that can reasonably be

considered to have been issued in relation to the acquisition of the affiliate shares, and

- the amount of any gain realized by the corporation resident in Canada or by the foreign affiliate of the corporation resident in Canada, as the case may be, under an agreement that provides for the purchase, sale or exchange of currency, or from the disposition of a currency, which agreement or currency, as the case may be, can reasonably be considered to have been entered into or acquired by the corporation resident in Canada, by the foreign affiliate of the corporation resident in Canada, or by the partnership, as the case may be, for the principal purpose of hedging the foreign exchange exposure arising in connection with the acquisition of the affiliate shares.

Refer to the coming-into-force commentary below to determine the coming-into-force dates for this new subsection.

**Loss Limitation - Disposition of Partnership Interest**

ITA
93(2.3)

Subsection 93(2.3) of the Act provides rules for the purpose of determining the allowable capital loss of a corporation resident in Canada from the disposition by a partnership of an interest in another partnership that has interests in shares of the capital stock of a foreign affiliate of the corporation resident in Canada and for determining the allowable capital loss of a foreign affiliate of the corporation resident in Canada from a disposition by a partnership of an interest in another partnership that has interests in shares of the capital stock of another foreign affiliate of the corporation resident in Canada that would not be excluded property if the shares were owned by the foreign affiliate.

The amount of the allowable capital loss otherwise determined is reduced by ½ of the exempt dividends received, on the share or a share for which the share was substituted, by the corporation resident in Canada, by another corporation resident in Canada that is related to the corporation, or by a foreign affiliate of either of those corporations resident in Canada (to the extent that the exempt dividends have not already reduced losses or allowable capital losses of those corporations or foreign affiliates under subsection 93(2), (2.1), (2.2) or (2.3) of the Act). The term “exempt dividend” is defined in subsection 93(3) of the Act.

Subsection 93(2.3) is being amended to permit the corporation resident in Canada or its foreign affiliate to restore an allowable capital loss from a disposition by a partnership of an interest in another partnership that has interests in shares of the capital stock of a foreign affiliate of the corporation resident in Canada to the extent of the lesser of two amounts.

- The first amount is the reduction of the allowable capital loss attributable to exempt dividends.

- The second amount is one-half of the total of the following gains determined in respect of the corporation resident in Canada or the foreign affiliate, as the case may be,

  - The foreign exchange gain arising on the settlement of an obligation issued or incurred to acquire the share.

  - The foreign exchange gain arising on the redemption, acquisition or cancellation of shares issued to acquire the share.

  - The gain arising under an agreement that provides for the purchase, sale or exchange of a currency, or from the disposition of a currency, that was entered into or acquired for hedging the foreign exchange exposure arising in connection with the acquisition of the share.

First, the formula in subsection 93(2.3) is being amended by adding the new variable "D" and will read as follows:

$$A - (B - C) \underline{+ D}$$

Second, the addition to the allowable capital loss under new variable "D" will be determined as the lesser of:

- The reduction of the allowable capital loss in respect of exempt dividends (determined as (B - C) in the formula), and

- ½ of the total of the following amounts determined in respect of the corporation resident in Canada or the foreign affiliate of the corporation resident in Canada, as the case may be,

  - the amount of the capital gain of the corporation resident in Canada, of the foreign affiliate of the corporation resident in Canada, or of the partnership (to the extent that such a gain

is reasonably attributable to the corporation resident in Canada, or to the foreign affiliate of the corporation resident in Canada, as the case may be) determined under paragraph 39(2)(*a*) for the taxation year that includes that time in respect of

- the settlement or extinguishment of an obligation of the corporation resident in Canada, of the foreign affiliate of the corporation resident in Canada, of the partnership or of the other partnership, as the case may be, that can reasonably be considered to have been issued or incurred in relation to the acquisition of the affiliate shares, or

- the redemption, acquisition or cancellation of a share of the corporation resident in Canada or of the foreign affiliate of the corporation resident in Canada, as the case may be, or of an interest in the partnership or in the other partnership, as the case may be, that can reasonably be considered to have been issued in relation to the acquisition of the affiliate shares, and

• the amount of any gain realized by a partnership (to the extent that such gain is reasonably attributable to the corporation resident in Canada or to the foreign affiliate of the corporation resident in Canada, as the case may be), by the corporation resident in Canada or by the foreign affiliate of the corporation resident in Canada, as the case may be, under an agreement that provides for the purchase, sale or exchange of currency, or from the disposition of a currency, which agreement or currency, as the case may be, can reasonably be considered to have been entered into or acquired by the partnership, by the corporation resident in Canada or by the foreign affiliate of the corporation resident in Canada, as the case may be, for the principal purpose of hedging the foreign exchange exposure arising in connection with the acquisition of the affiliate shares.

Refer to the coming-into-force commentary below to determine the coming-into-force for this new subsection.

**Coming-into-Force (ITA 93(2), 93(2.1), 93(2.2) and 93(2.3))**

The amendments to subsections 93(2), 93(2.1), 93(2.2) and (2.3) of the Act apply to taxation years, of foreign affiliates of a taxpayer, that begin after Announcement Date. However, if the taxpayer so elects in writing and files that election with the Minister of National Revenue on or before the taxpayer's filing-due date for the taxation year in which these amendments are assented to, the amendments will apply

taxation years of the taxpayer and all foreign affiliates of the taxpayer that begin after 1994.

**Clause 133**

**Foreign Affiliates**

ITA
95

Section 95 of the Act defines a number of terms and provides rules relating to the taxation of resident shareholders of foreign affiliates.

**Global Section 95 Election**

In this set of proposals, there are a number of amendments to section 95 of the Act, and to section 5907 of the Regulations, that apply to taxation years, of a foreign affiliate of a taxpayer, that begin or end after various specified dates. However, where a taxpayer so elects in writing and files the election (referred to in this commentary as the "Global Section 95 Election") with the Minister of National Revenue before the taxpayer's filing-due date for the taxpayer's taxation year that includes the day on which these amendments are assented to, all of those measures apply to taxation years of all foreign affiliates, of the taxpayer, that begin after 1994. This set of proposals provides that, notwithstanding subsections 152(4) to (5) of the Act, the Minister of National Revenue can make any assessment of a taxpayer's tax, interest and penalties payable under the Act for any taxation year that is necessary to take the election into account.

Note that the Fresh Start Section 95 Election (described below) and the Global Section 95 Election are separate elections. As well, it should be noted that various important amendments to section 95 of the Act have separate elections that can be made by taxpayers.

The following amendments to the Act and to the Regulations are covered by the Global Section 95 Election package:

(A) Amendments to the Act:

- paragraphs (*a*), (*c*) and (*c*.1) of the definition "excluded property" in subsection 95(1),

- paragraph (*b*) of the definition "investment business" in subsection 95(1),

- subclauses 95(2)(*a*)(i)(A)(II) and (B)(II) and 95(2)(*a*)(ii)(A)(II) and (B)(II), clause 95(2)(*a*)(ii)(C), clause 95(2)(*a*)(ii)(E) and subparagraphs 95(2)(*a*)(v) and (vi),

- the portion of paragraph 95(2)(*f*) that is after subparagraph 95(2)(*f*)(ii) and before subparagraph 95(2)(*f*)(iii),

- paragraphs 95(2)(*f*.1), (*f*.2) and (*g*) to (*g*.02),

- paragraph 95(2)(*i*),

- paragraphs 95(2)(*o*) to (*t*),

- paragraph 95(2.1)(c),

- preamble of subsection 95(2.2),

- subsection 95(2.41), and

- paragraph 95(3)(*d*) of the Act.

(B) Amendments to the Regulations:

- paragraph (*b*) of the definition "earnings" in Regulation 5907(1),

- paragraph (*b*) of the definition "exempt deficit" in Regulation 5907(1),

- paragraph (*a*.1) of the definition "exempt earnings" in Regulation 5907(1),

- subparagraph (*d*)(ii) of the definition "exempt earnings" in Regulation 5907(1),

- the preamble, paragraph (*c*), and the "postamble", of the definition "exempt loss" in Regulation 5907(1),

- the definition "loss" in Regulation 5907(1),

- subparagraph (*d*)(i) of the definition "net earnings" in Regulation 5907(1),

- subparagraph (*d*)(i) of the definition "net loss" in Regulation 5907(1),

- paragraph (*b*) of the definition "taxable deficit" in Regulation 5907(1),

- subparagraphs (*b*)(i.1), (iv) and (v) of the definition "taxable loss" in Regulation 5907(1), and

- paragraphs 5907(2.7)(*a*) and (*b*) of the Regulations.

If a Global Section 95 Election is made by a taxpayer, the amendments to the definitions "exempt earnings" and "exempt loss" in Regulation 5907(1) that implement the new concept of "qualifying member" will apply only for foreign affiliate taxation years that end after 1999. For more detail, see the commentary to the definitions "exempt earnings" and "exempt loss" in Regulation 5907(1).

Note that this set of proposals provides for the possibility of a total revocation of the Global Section 95 Election. If a taxpayer has made what would otherwise be a valid Global Section 95 Election, and the taxpayer has, on or before the taxpayer's filing-due date for the taxpayer's taxation year that includes the day that is the third anniversary of the day on which the amending legislation enacting this set of proposals is assented to, filed with the Minister of National Revenue a notice in writing to revoke the election, the election is deemed never to have been made. This set of proposals provides that, notwithstanding subsections 152(4) to (5) of the Act, the Minister of National Revenue can make any assessment of a taxpayer's tax, interest and penalties payable under the Act for any taxation year that is necessary to take the revocation into account.

**Fresh Start Section 95 Election**

This set of proposals contains a number of amendments to section 95 of the Act, and to section 5907 of the Regulations, that apply to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002. However, where a taxpayer so elects in writing and files the election (referred to in this commentary as the "Fresh Start Section 95 Election") with the Minister of National Revenue before the taxpayer's filing-due date for the taxpayer's taxation year that includes the day on which these amendments are assented to, all of those amendments apply to taxation years of all foreign affiliates, of the taxpayer, that begin after 1994. This set of proposals provides that, notwithstanding subsections 152(4) to (5) of the Act, the Minister of National Revenue can make any assessment of a taxpayer's tax, interest and penalties payable under the Act for any taxation year that is necessary to take the election into account.

Note that the Global Section 95 Election and the Fresh Start Section 95 Election are separate elections.

The following amendments to the Act and to the Regulations are covered by the Fresh Start Section 95 Election package:

- the definition "taxable Canadian business" in subsection 95(1),

- paragraphs 95(2)(*j*.1) and (*j*.2) and 95(2)(*k*), (*k*.1) and (*k*.4) to (*k*.7), and

- subsections 5907(2.9) and (2.91) of the Regulations.

See the commentary to paragraph 95(2)(*k*) for additional information with respect to transitional provisions.

Note that this set of proposals provides for the possibility of a total revocation of the Fresh Start Section 95 Election. If a taxpayer has made what would otherwise be a valid Fresh Start Section 95 Election, and the taxpayer has, on or before the taxpayer's filing-due date for the taxpayer's taxation year that includes the day that is the third anniversary of the day on which the amending legislation enacting this set of proposals is assented to, filed with the Minister of National Revenue a notice in writing to revoke the election, the election is deemed never to have been made. This set of proposals provides that, notwithstanding subsections 152(4) to (5) of the Act, the Minister of National Revenue can make any assessment of a taxpayer's tax, interest and penalties payable under the Act for any taxation year that is necessary to take the revocation into account.

**Definitions**

ITA
95(1)

Subsection 95(1) of the Act defines a number of terms for the purposes of subdivision i of Division B of Part I of the Act that are used in connection with the rules dealing with the taxation of resident shareholders of foreign affiliates.

**"controlled foreign affiliate"**

In subsection 95(1) of the Act, a "controlled foreign affiliate", at any time, of a taxpayer is defined to mean a foreign affiliate of the taxpayer that is, at that time, controlled by

- the taxpayer,

- the taxpayer and not more than four other persons resident in Canada,

- not more than four persons resident in Canada, other than the taxpayer,

- a person or persons with whom the taxpayer does not deal at arm's length, or

- the taxpayer and a person or persons with whom the taxpayer does not deal at arm's length.

The definition "controlled foreign affiliate" is amended to provide that a "controlled foreign affiliate", at any time, of a taxpayer resident in Canada means a foreign affiliate of the taxpayer at that time that

- is, at that time, a controlled foreign affiliate of the taxpayer because of proposed new paragraph 94.1(2)(*h*) of the Act,

- is, at that time, controlled by the taxpayer,

- would, at that time, be controlled by the taxpayer if the taxpayer owned each share of the capital stock of the foreign affiliate that is owned, at that time, by

  - the taxpayer,

  - each person that does not deal at arm's length with the taxpayer,

  - each of not more than four persons (other than the taxpayer or a person that does not deal at arm's length with the taxpayer) resident in Canada, and

  - each person that does not deal at arm's length with any of the four persons resident in Canada.

For information about proposed new paragraph 94.1(2)(*h*) of the Act, see the October 30, 2003 legislative proposals released by the Department of Finance dealing with non-resident trusts and foreign investment entities.

With respect to applying the definition "controlled foreign affiliate", note the rules in proposed new paragraphs 95(2)(*u*) to (*x*). For more detail, see the commentaries for those paragraphs.

The new definition of "controlled foreign affiliate" applies to taxation years, of a foreign affiliate of a taxpayer, that begin after 1995. However, for taxation years, of a foreign affiliate of a taxpayer that begin after 2002 and on or before Announcement Date, the term "controlled foreign affiliate" would be defined as described below:

*"controlled foreign affiliate", at any time, of a taxpayer resident in Canada means a foreign affiliate of the taxpayer that*

- *is, at that time, a controlled foreign affiliate of the taxpayer because of proposed new paragraph 94.1(2)(h),*

- *is, at that time, controlled by the taxpayer, or*

- *would, at that time, be controlled by the taxpayer if the taxpayer owned each share of the capital stock of the foreign affiliate that is owned, at that time, by*

  - *the taxpayer and not more than four other persons resident in Canada,*

  - *not more than four persons resident in Canada (other than the taxpayer or persons with whom the taxpayer does not deal at arm's length), or*

  - *the taxpayer and each person with whom the taxpayer does not deal at arm's length.*

For taxation years, of a foreign affiliate of a taxpayer that begin after 1995 and before 2003, the term "controlled foreign affiliate" would be defined as described below:

*"controlled foreign affiliate", at any time, of a taxpayer resident in Canada means a foreign affiliate of the taxpayer that*

- *is, at that time, controlled by the taxpayer, or*

- *would, at that time, be controlled by the taxpayer if the taxpayer owned each share of the capital stock of the foreign affiliate that is owned, at that time, by*

  - *the taxpayer and not more than four other persons resident in Canada,*

  - *not more than four persons resident in Canada (other than the taxpayer or persons with whom the taxpayer does not deal at arm's length), or*

  - *the taxpayer and each person with whom the taxpayer does not deal at arm's length.*

**"entity"**

The new definition "entity" in subsection 95(1) of the Act is relevant for proposed new subsection 95(3.6). An entity is defined as including an association, a corporation, a fund, a natural person, a joint venture, an organization, a partnership, a syndicate and a trust.

This new definition applies in respect of taxation years, of a foreign affiliate of a taxpayer, that end on or after December 20, 2002.

**"excluded property"**

The definition "excluded property" in subsection 95(1) of the Act is relevant for the purposes of computing the foreign accrual property income (FAPI) and the tax surpluses and deficits of a foreign affiliate of a taxpayer. Under the definition "foreign accrual property income" in subsection 95(1), capital gains and losses from the disposition of excluded property are disregarded in computing FAPI except in the circumstances set out in the description of B in the definition of FAPI.

Paragraph (*a*) of the definition "excluded property" provides that any property used or held by the foreign affiliate principally for the purpose of gaining or producing income from an active business is excluded property under that definition. Paragraph (*a*) of the definition is amended to clarify that property does not meet the requirements of that paragraph unless the property is used or held by the foreign affiliate principally for the purpose of gaining or producing income from an active business that is carried on by it.

Paragraph (*b*) of the definition "excluded property" provides that shares owned by a foreign affiliate of a taxpayer in the capital stock of another foreign affiliate of the taxpayer are excluded property if all or substantially all of the property of the other foreign affiliate is excluded property. Paragraph (*b*) of the definition is amended to clarify that shares owned by a foreign affiliate of a taxpayer in the capital stock of another foreign affiliate of the taxpayer do not meet the requirements of that paragraph unless all or substantially all of the fair market value of the property of the other foreign affiliate is attributable to property of that other foreign affiliate that is excluded property.

Paragraph (*c*) of the definition "excluded property" provides that an amount receivable is excluded property of a foreign affiliate of a taxpayer if the interest on the amount receivable is, or would be if interest were payable on it, income from an active business because of subparagraph 95(2)(*a*)(ii) of the Act. Paragraph (*c*) of the definition is amended to broaden the meaning of "excluded property"

to include property all or substantially all of the income from which would be income from an active business including income that would be deemed to be income from an active business by amended paragraph 95(2)(*a*) if that paragraph were read without reference to subparagraph (v). For additional information, see the commentary to paragraph 95(2)(*a*).

New paragraph (*c*.1) is added to the definition "excluded property" to include property arising under or as a result of an agreement that

- provides for the purchase, sale or exchange of currency, and

- can reasonably be considered to have been made by a foreign affiliate of a taxpayer to reduce the affiliate's risk, with respect to an amount that was receivable under an agreement that relates to the sale of excluded property or with respect to an amount that was receivable and was a property described in amended paragraph (*c*) of the definition, of fluctuations in the value of the currency in which the amount receivable was denominated.

New paragraph (*c*.1) of the definition "excluded property" will, for example, address a situation where the affiliate enters into an agreement (the "sale agreement"), relating to the sale of excluded property, in which the amount receivable under the sale agreement is denominated in a currency other than the affiliate's calculating currency, and then, in order to reduce the affiliate's risk of fluctuations in the value of the currency in which the amount receivable under the sale agreement is denominated, enters into a currency hedging agreement with respect to all or a portion of that amount receivable. In such a situation, new paragraph (*c*.1) ensures that the income or loss from that hedge receives the same income characterization as the income or loss from the property being hedged; i.e., the income or loss from that hedge is considered to be income or loss from the sale of excluded property.

New paragraphs (*a*), (*c*) and (*c*.1) of the definition "excluded property" apply to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002. Those paragraphs are part of the Global Section 95 Election package described at the beginning of the commentary to section 95.

New paragraph (*b*) of the definition "excluded property" applies to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002.

**"foreign accrual property income"**

The definition "foreign accrual property income" in subsection 95(1) of the Act is relevant for the purposes of section 91 of the Act and for the purposes of computing the tax surpluses and deficits of the foreign affiliate of a taxpayer. Section 91 of the Act provides rules for determining amounts that a taxpayer resident in Canada is to include in computing that taxpayer's income for a particular year as income from a share of a controlled foreign affiliate of that taxpayer.

First, the description of B in the definition "foreign accrual property income" in subsection 95(1) is amended to include income (other than income included in the description of A in the definition "foreign accrual property income") and capital gains, as the case may be,

- from dispositions of excluded property where any of paragraphs 88(3)(*a*) and 95(2)(*c*), (*c*.2), (*d*), (*d*.1), (*e*), (*e*.1), (*e*.3) to (*e*.5) and (*f*.4) of the Act applies in respect of the disposition and, and

- gains arising under subsection 40(3) in respect of a share because of a dividend referred to in subparagraph 95(2)(*e*.3)(iv) or (*e*.4)(v) on the share,

which income or capital gain can reasonably be considered to have accrued after the affiliate's 1975 taxation year.

Second, the description of E in the definition of "foreign accrual property income" is amended to remove the reference to dispositions of excluded property to which none of paragraphs 95(2)(*c*), (*d*) or (*e*) apply, and replace it with a reference to dispositions of excluded property.

These amendments apply to taxation years, of a foreign affiliate of a taxpayer, that end on or after December 20, 2002.

**"investment business"**

The definition "investment business" in subsection 95(1) of the Act is relevant for the purposes of the definitions "income from property" and "foreign accrual property income" in that subsection.

Under the definition "investment business", the investment business of a foreign affiliate of a taxpayer means, in general, a business carried on by the affiliate the principal purpose of which is to derive income from property, income from the insurance or reinsurance of risks, income from the factoring of trade accounts receivable, or profits from the disposition of investment property, unless it is

established that the business meets the requirements of paragraphs (*a*) and (*b*) of that definition.

Paragraph (*a*) of the definition "investment business" requires that the affiliate conduct the business principally with arm's length persons and that the business be either

- carried on by the affiliate as a foreign bank, a trust company, a credit union, an insurance corporation or a trader or dealer in securities or commodities, the activities of which are regulated in the country in which the business is principally carried on (subparagraph (*a*)(i) of the definition), or

- the development of real estate for sale, the lending of money, the leasing or licensing of property or the insurance or reinsurance of risks (subparagraph (*a*)(ii) of the definition).

In general terms, paragraph (*b*) of the definition requires that the affiliate or (as described in the preamble to paragraph (*b*) of the definition, where the affiliate carries on the business as a member of a partnership (except where the affiliate is a "specified member" of the partnership)), the partnership

- employs more than 5 employees full time in the active conduct of the business (subparagraph (*b*)(i) of the definition), or

- employs the equivalent of more than 5 employees in the active conduct of the business, taking into account only services provided by the employees of the affiliate and services provided outside Canada by employees of

  - a corporation related to the affiliate (clause (*b*)(ii)(A) of the definition), or

  - members of the partnership, other than a "specified member" of the partnership (clause (*b*)(ii)(B) of the definition).

The definition "investment business" is amended in the following ways.

First, subparagraph (*a*)(i) of definition is amended to refer to a business carried on by a foreign affiliate as a foreign bank, a trust company, a credit union, an insurance corporation or a trader or dealer in securities or commodities, the activities of which are regulated under the laws

- of each country in which the business is carried on through a permanent establishment (the definition, in proposed new

Regulation 8202, of "permanent establishment" applies for this purpose) in that country and of the country under whose laws the affiliate is governed and any of exists, was (unless the affiliate was continued in any jurisdiction) formed or organized, or was last continued,

- of the country in which the business is principally carried on, or

- if the affiliate is related to a non-resident corporation, of the country under whose laws that non-resident corporation is governed and any of exists, was (unless that non-resident corporation was continued in any jurisdiction) formed or organized, or was last continued, if those regulating laws are recognized under the laws of the country in which the business is principally carried on and all of those countries are members of the European Union.

Second, the "preamble" to paragraph (*b*) of the definition "investment business" is amended so that the concept of "member of a partnership (except where the affiliate is a specified member of the partnership)" is replaced by the concept of "qualifying member of a partnership".

Third, clause (*b*)(ii)(B) of the definition "investment business" is replaced by new clauses (*b*)(ii)(B) and (C) so that, in general terms, in determining whether the affiliate or the partnership employs the equivalent of more than 5 employees full time in the active conduct of the business, there is taken into account only services provided by the employees of the affiliate and services provided outside Canada by employees of

- a corporation related to the affiliate (clause (*b*)(ii)(A) of the definition), or

- where the affiliate carries on the business as a member of the partnership,

    - a person who was a "qualifying member" of the partnership,

    - a designated corporation in respect of the affiliate (if the affiliate was a qualifying member of the partnership), or

    - a designated partnership in respect of the affiliate (if the affiliate was a qualifying member of the partnership), or

- where the affiliate carries on the business (otherwise than as a member of the partnership),
    - a corporation that was a "qualifying shareholder" of the affiliate,
  - a designated corporation in respect of the affiliate, or
  - a designated partnership in respect of the affiliate.

Fourth, the "postamble" to subparagraph (*b*)(ii) of the definition "investment business" is amended to reflect the changes to clauses (*b*)(ii)(B) and (C) of that definition.

The expression "qualifying member" is a newly introduced term and is defined in new paragraph 95(2)(*o*) for the purposes of subdivision i of Division B of Part I of the Act. That expression is, for the purposes of the Act generally, defined in amended subsection 248(1) of the Act as a person who would, at the relevant time, be determined to be a qualifying member of the partnership under paragraph 95(2)(*o*). For more information about the expression "qualifying member", see the commentary to paragraph 95(2)(*o*) and subsection 248(1).

The expressions "qualifying shareholder", "designated corporation" and "designated partnership" are also newly introduced terms and are defined in new paragraphs 95(2)(*p*), (*s*) and (*t*), respectively. For additional information, see the commentary to those paragraphs.

Amended subparagraph (*a*)(i) of the definition "investment business" applies to taxation years, of a foreign affiliate of a taxpayer, that begin after 1999.

The amendments to the "preamble" of paragraph (*b*), and to subclause (*b*)(ii)(B)(I), of the definition "investment business", in conjunction with the new definition "qualifying member", ensure that, in applying paragraph (*b*) of the definition "investment business", limited partners who are qualifying members of a limited partnership are treated in the same manner as general partners of a general partnership. These amendments also ensure that, even if the activities of the relevant partner do not meet the business activity requirements in new subparagraph 95(2)(*o*)(i), a partnership may qualify under the "preamble" to paragraph (*b*) of the definition "investment business" (or a partner may qualify under clause (*b*)(ii)(C) of that definition) if the relevant partner has an equity interest in the partnership that meets the criteria set out in new subparagraph 95(2)(*o*)(ii). For more detail, see the commentary to new paragraph 95(2)(*o*).

New clause (*b*)(ii)(C) of the definition "investment business", in conjunction with the new definition "qualifying shareholder", ensures that in the case where the affiliate carries on the business (other than as a member of the partnership), services that are rendered outside of Canada by a corporation that was a "qualifying shareholder" of the affiliate, and otherwise meet the conditions set out in paragraph (*b*) of the definition, may be taken into account in determining whether the "more than 5 employees full time" equivalency test in subparagraph (*b*)(ii) is met. For more detail, see the commentary to the definition "qualifying shareholder" in paragraph 95(2)(*p*).

New subclauses (*b*)(ii)(B)(II), (III) and (C)(II) and (III) expand the scope of partnerships or corporations that may be taken into account in determining whether the "more than 5 employees full time" equivalency test in subparagraph (*b*)(ii) is met by introducing the concepts of a designated corporation and a designated partnership. For additional information, see commentary to paragraphs 95(2)(*s*) and (*t*).

The amendments to the "preamble" of paragraph (*b*), to clauses (*b*)(ii)(B) and (C), and to the "postamble" of subparagraph (*b*)(ii), of the definition "investment business" apply to taxation years, of a foreign affiliate of a taxpayer, that end after 1999. These amendments are included in the Global Section 95 Election package described in the beginning of the commentary to section 95.

**"taxable Canadian business"**

Subsection 95(1) of the Act is amended to add the new definition "taxable Canadian business". This expression is used in new paragraphs 95(2)(*j*.1), (*k*), (*k*.2) and (*k*.4) of the Act. For more detail, see the commentaries to those paragraphs.

A "taxable Canadian business", at any time of a foreign affiliate of a taxpayer resident in Canada or of a partnership of which a foreign affiliate of a taxpayer resident in Canada is a member (which foreign affiliate or partnership is referred to in that definition as the "operator"), is a business the income from which, for the operator's taxation year or fiscal period that includes that time, is income

- that is included in computing the foreign affiliate's taxable income earned in Canada under subparagraph 115(1)(*a*)(ii), and

- that is not, because of a tax treaty with a country, exempt from tax under Part I of the Act.

In connection with the application of the definition “taxable Canadian business”, note the rules in proposed new paragraph 95(2)(*k*.7). For more detail, see the commentary to that paragraph.

The amendment to add the new definition “taxable Canadian business” applies to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002. This amendment is included in the Fresh Start Section 95 Election package described at the beginning of the commentary to section 95.

Also note that the definition “tax treaty” in subsection 248(1) is applicable to the 1998 and subsequent taxation years. Accordingly, these amendments ensure, in effect, that, in applying the definition “taxable Canadian business” for the 1997 and prior taxation years of all foreign affiliates of the taxpayer in the case where a taxpayer has made a Fresh Start Section 95 Election, the reference in paragraph (*b*) of the definition “taxable Canadian business” to the expression “tax treaty” is to be read as a reference to a “comprehensive agreement or convention for the elimination of double taxation on income, between the Government of Canada and the government of another country, which has the force of law in Canada at that time”.

**Determination of Certain Components of Foreign Accrual Property Income**

ITA
95(2)

Subsection 95(2) of the Act provides rules for determining the income, of a foreign affiliate of a taxpayer resident in Canada, from a particular source. A foreign affiliate is considered to have three sources of income - income from property, income from a business other than an active business and income from an active business. This sourcing is important since the affiliate’s income from property and the affiliate’s income from a business other than an active business are included in the foreign accrual property income (FAPI) of the affiliate. Where the affiliate is a controlled foreign affiliate of the taxpayer, the taxpayer’s share of the affiliate’s FAPI must be included, under section 91 of the Act, in the taxpayer’s income for Canadian tax purposes whether or not the income is distributed. The income of a foreign affiliate of a taxpayer from an active business is included, under section 90 of the Act, in the taxpayer’s income for Canadian tax purposes only when paid to the shareholder as a dividend.

ITA
95(2)(*a*)

Paragraph 95(2)(*a*) of the Act characterizes, in certain circumstances, amounts that would otherwise be income from property as income from an active business. More particularly, subparagraphs 95(2)(*a*)(i) to (iv) provide that particular income of a foreign affiliate of a taxpayer, in respect of which the taxpayer has a qualifying interest throughout a taxation year of the affiliate, from sources in a country (other than Canada) that would otherwise be income from property of the affiliate for the year, will be included in computing the income from an active business of the affiliate for the year.

However, paragraph 95(2)(*a*) does not

- require amounts that would otherwise be "losses" from property of the affiliate to be included in computing the income from an active business of the affiliate, or

- require amounts that would otherwise be income or losses from property of the affiliate to be included in computing the "loss" from an active business of the affiliate.

Paragraph 95(2)(*a*) is amended so that throughout that paragraph, except clauses 95(2)(*a*)(ii)(D) and (E), the word "income" is replaced with the words "income or loss".

In general, these amendments to paragraph 95(2)(*a*) ensure that, provided that the conditions specified in that paragraph are satisfied,

- amounts that would otherwise be "losses" from property of the affiliate can be included in computing the income from an active business of the affiliate, and

- amounts that would otherwise be income or losses from property of the affiliate can be included in computing the "loss" from an active business of the affiliate.

The "preamble" of paragraph 95(2)(*a*) is also amended to broaden the scope of the paragraph to include those foreign affiliates in which the taxpayer does not have a qualifying interest but to which the taxpayer is related throughout the year. Those foreign affiliates would be controlled foreign affiliates of the taxpayer. (Refer to the commentary on new amended subclause 95(2)(*a*)(ii)(D)(III) for information regarding a similar change.)

These amendments to paragraph 95(2)(*a*) apply to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002.

ITA
95(2)(*a*)(i)

In general terms, subparagraph 95(2)(*a*)(i) of the Act permits a particular foreign affiliate of a taxpayer, in respect of which the taxpayer has a qualifying interest, to include, in its active business income, its property income that

- is derived by it from activities that can reasonably be considered to be directly related to active business activities carried on in a country (other than Canada) by a person that is
  - any other non-resident corporation to which the particular affiliate and the taxpayer are related throughout the year (for convenience referred to as Case 1), or
  - the taxpayer, where the taxpayer is a life insurance corporation resident in Canada throughout the year (for convenience referred to as Case 2), and
- would, if that person were a foreign affiliate of the taxpayer and the income were earned by it, be included in computing the active business income of that person.

Case 2 deals with the situation where a foreign affiliate of the taxpayer in respect of which the taxpayer has a qualifying interest performs the treasury activities for the foreign branch of a Canadian multinational life insurer. The income of the treasury activities could be included in the active business income of the affiliate if the income would be active business income of the foreign branch if it were a foreign affiliate of the taxpayer and it earned the income.

However, Case 2 would not apply where, for example, a particular wholly-owned Canadian subsidiary of the taxpayer is a life insurance corporation resident in Canada that has a foreign branch and a foreign affiliate of the taxpayer in respect of which the taxpayer has a qualifying interest performs the treasury activities for the foreign branch. This is the case because the wholly-owned Canadian subsidiary of the taxpayer does not have a qualifying interest in the foreign affiliate of the taxpayer.

In order to address that concern, subclauses 95(2)(*a*)(i)(A)(II) and (B)(II) are amended to extend Case 2 to situations where the foreign branch is a foreign branch of a life insurance corporation resident in Canada that is the taxpayer, a person that controls the taxpayer or a person that is controlled by the taxpayer.

The amendments to subclauses 95(2)(*a*)(i)(A)(II) and (B)(II) apply to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002. These amendments are included in the Global Section 95 Election package described at the beginning of the commentary to section 95.

As noted in the opening commentary to paragraph 95(2)(*a*), amendments made to that paragraph ensure that, throughout subparagraph 95(2)(*a*)(i), the word "income" is replaced with the words "income or loss". For further detail on those amendments and on their coming-into-force provisions, refer to that commentary.

ITA
95(2)(*a*)(ii)

Subparagraph 95(2)(*a*)(ii) of the Act provides that income that would otherwise be income from property for a taxation year of a particular foreign affiliate of a taxpayer, in respect of which the taxpayer has a qualifying interest, will be included in the particular affiliate's income from an active business for the year to the extent that the income is derived from amounts paid or payable, directly or indirectly, to the particular affiliate or a partnership of which it is a member

- by a non-resident corporation to which the particular affiliate and the taxpayer are related throughout the year or by a partnership of which the non-resident corporation is a member (other than where it is a specified member, as defined in subsection 248(1) of the Act, of the partnership at any time in a fiscal period of the partnership that ends in the year) to the extent that those amounts paid or payable are for expenditures (either an expenditure of a current nature or an expenditure in respect of which an allowance is claimed) that would, if the non-resident corporation or the partnership were a foreign affiliate of the taxpayer, be deductible in the year or a subsequent taxation year by it in computing the amounts prescribed to be its earnings or loss from an active business, other than an active business carried on in Canada (clause 95(2)(*a*)(ii)(A));

- by another foreign affiliate of the taxpayer in respect of which the taxpayer has a qualifying interest throughout the year or by a partnership of which the other foreign affiliate of the taxpayer is a member (other than where the other affiliate is a specified member of the partnership at any time in a fiscal period of the partnership that ends in the year) to the extent that those amounts paid or payable are for expenditures (either an expenditure of a current nature or an expenditure in respect of which an allowance is claimed) that are or would, if the partnership were a foreign affiliate of the taxpayer, be deductible in the year or a subsequent

taxation year by the other affiliate or the partnership in computing the amounts prescribed to be its earnings or loss from an active business, other than an active business carried on in Canada (clause 95(2)(*a*)(ii)(B));

- by a partnership where the particular affiliate is a member of the partnership (other than where it is a "specified member" of the partnership at any time in a fiscal period of the partnership that ends in the year) to the extent that those amounts paid or payable are for expenditures (either an expenditure of a current nature or an expenditure in respect of which an allowance is claimed) that would, if the partnership were a foreign affiliate of the taxpayer, be deductible in the year or a subsequent taxation year in computing the amounts prescribed to be its earnings or loss from an active business carried on by it outside Canada (clause 95(2)(*a*)(ii)(C));

- by another foreign affiliate of the taxpayer that is related to the particular affiliate and the taxpayer throughout the year (the "second affiliate") pursuant to a legal obligation to pay interest on borrowed money used to acquire, or on an amount payable for the acquisition of, property where

  - the property is excluded property of the second affiliate that is shares of another foreign affiliate of the taxpayer in respect of which the taxpayer has a qualifying interest throughout the year (the "third affiliate"),

  - the second affiliate and the third affiliate are resident in, and subject to income taxation in, the same country, and

  - the amounts paid or payable are relevant in computing the liability for taxes of the members of a corporate group composed of the second affiliate and one or more other foreign affiliates of the taxpayer which are resident in, and not exempt from income taxation in, the same country as the second affiliate and in respect of which the taxpayer has a qualifying interest throughout the year (clause 95(2)(*a*)(ii)(D)); or

- by the taxpayer, where the taxpayer is a life insurance corporation resident in Canada, to the extent that those amounts paid or payable are for expenditures that are deductible in the year or a subsequent taxation year by the life insurance corporation resident in Canada in computing its income or loss from carrying on its insurance business outside Canada and not in Canada (clause 95(2)(*a*)(ii)(E)).

A foreign affiliate of a taxpayer, in respect of which the taxpayer has a qualifying interest, will be precluded from using clauses

95(2)(*a*)(ii)(A), (B) and (C) if the relevant member of the partnership referred to in those clauses is a specified member of the partnership.

Generally, a "specified member" of a partnership in a fiscal period of the partnership is defined in subsection 248(1) of the Act as being

- a member who was a limited partner (within the meaning assigned by subsection 96(2.4)) of the partnership at any time in the fiscal period, or

- a member who, throughout that part of the fiscal period that a business of the partnership is ordinarily carried on and during which the member was a member of the partnership, was neither

  - actively engaged in the business of the partnership (otherwise than in the financing of the business), nor

  - carrying on, otherwise than as a member of a partnership, a similar business as that carried on by the partnership (otherwise than in the financing of the business).

Subparagraph 95(2)(*a*)(ii) is amended in the following ways.

First, clauses 95(2)(*a*)(ii)(A) to (C) are amended so that the condition requiring the relevant member of the partnership to be a member of the partnership (otherwise than as a specified member of the partnership) is replaced by the condition requiring the relevant member to be a "qualifying member" of the partnership throughout each period, in the fiscal period of the partnership that ends in the year, in which the relevant member was a member of the partnership. The expression "qualifying member" is a new term. It is defined in new paragraph 95(2)(*o*) for the purposes of subdivision i of Division B of Part I of the Act, and, defined in subsection 248(1) for the purposes of the Act generally, as being a person that would at the relevant time be determined under paragraph 95(2)(*o*) to be a qualifying member of the partnership. For more detail on the definition "qualifying member", see the commentary to paragraph 95(2)(*o*) and subsection 248(1).

The amendments to clauses 95(2)(*a*)(ii)(A) to (C), in conjunction with the new definition "qualifying member", ensure that, in applying those clauses, limited partners of limited partnerships that are qualifying members are treated in the same manner as general partners of general partnerships. Those provisions also ensure that, even if the activities of the relevant person do not meet the business

activity requirements in new subparagraph 95(2)(*o*)(i), a partnership may still qualify under clause 95(2)(*a*)(ii)(A), (B) or (C) if the relevant person has an equity interest in the partnership that meets the criteria set out in new subparagraph 95(2)(*o*)(ii). For more detail, see the commentary to new paragraph 95(2)(*o*).

Second, clause 95(2)(*a*)(ii)(D) is amended to

- introduce the concept of a particular period in the "preamble" to clause 95(2)(*a*)(ii)(D) and in subclause 95(2)(*a*)(ii)(D)(III),

- provide in subclause 95(2)(*a*)(ii)(D)(III) that a foreign affiliate of the taxpayer to which the taxpayer is related can be a "third affiliate" defined in that subclause,

- replace current subclause 95(2)(*a*)(ii)(D)(IV) with new subclauses 95(2)(*a*)(ii)(D)(IV) and (V), and

- remove the requirement that existed in current subclause 95(2)(*a*)(ii)(D)(V).

The "preamble" to clause (D) is amended to describe amounts paid or payable by the "second affiliate" as being in respect of a particular period which period is then the time frame during which the shares of the "third affiliate" must be excluded property.

Under existing subclause 95(2)(*a*)(ii)(D)(III), a foreign affiliate of a taxpayer cannot be a "third affiliate" defined in that subclause unless the foreign affiliate is a foreign affiliate of the taxpayer in respect of which the taxpayer has a qualifying interest. The amendment permits a foreign affiliate of the taxpayer that is related to the taxpayer to be a "third affiliate" defined in that subclause. Related foreign affiliates would be controlled foreign affiliates of the taxpayer.

Under existing subclause 95(2)(*a*)(ii)(D)(IV), the "second affiliate" and the "third affiliate" must be resident in and subject to income taxation in the same country. Thus, each of those affiliates must itself be subject to income taxation in that country and cannot be a flow-through entity under the income tax laws of that country. Amended subclauses 95(2)(*a*)(ii)(D)(IV) and (V) are intended to accommodate the case where the second affiliate, the third affiliate, or both, are such a flow-through entity.

New subclause 95(2)(*a*)(ii)(D)(IV) requires that the second affiliate and the third affiliate be resident in the same country for each of their taxation years (each of which taxation years is referred to as a "relevant taxation year" of the second affiliate or of the third affiliate, as the case may be) that end in the year.

New subclause 95(2)(*a*)(ii)(D)(V) requires that, in respect of each of the second affiliate and the third affiliate for each relevant taxation year of that affiliate, either

- that affiliate be subject to income taxation in that country in that relevant taxation year (sub-subclause 95(2)(*a*)(ii)(D)(V)1.), or

- the members or shareholders of that affiliate (which, for the purpose of sub-subclause 95(2)(*a*)(ii)(D)(V)2.), includes a person that has, directly or indirectly, an interest in a share of, or in an equity interest in, the affiliate) at the end of that relevant taxation year be subject to income taxation in that country on, in aggregate, all or substantially all of the income of that affiliate for that relevant taxation year in their taxation years in which that relevant taxation year ends or would be so subject to income taxation in that country if that affiliate had income for that relevant taxation year and the income of those members or shareholders for their taxation years in which that relevant taxation year ends consisted only of their share of income of that affiliate for that relevant taxation year (sub-subclause 95(2)(*a*)(ii)(D)(V)2.).

Current subclause 95(2)(*a*)(ii)(D)(V) contains the requirement that the amounts paid or payable by the second affiliate to the particular affiliate must be relevant in computing the liability for income taxes in that country of a corporate group composed of the second affiliate and one or more other foreign affiliates of the taxpayer (the shares of which are excluded property) that are resident in, and subject to income taxation in, that country and in respect of which the taxpayer has a qualifying interest throughout the year. Clause 95(2)(*a*)(ii)(D) is amended to remove the requirement contained in current subclause 95(2)(*a*)(ii)(D)(V).

Third, as noted above, current clause 95(2)(*a*)(ii)(E) provides for the recharacterization of certain amounts paid or payable to the particular affiliate, where the payer is the taxpayer and the taxpayer is a life insurance corporation resident in Canada, to the extent that those amounts are for expenditures that are deductible in the year or a subsequent taxation year by the taxpayer in computing its income or loss from carrying on its insurance business outside Canada and not in Canada.

Clause 95(2)(*a*)(ii)(E) is amended to provide for the recharacterization of certain amounts paid or payable to the particular affiliate, where the payer is a life insurance corporation that is resident in Canada and is the taxpayer, a person who controls the taxpayer or a person controlled by the taxpayer, to the extent that those amounts were for expenditures that are deductible in the year or in a subsequent taxation year by the life insurance corporation in computing its

income or loss from carrying on its life insurance business outside Canada and are not deductible in the year or a subsequent taxation year in computing its income or loss from carrying on its life insurance business in Canada.

For additional detail, see the commentary to subclauses 95(2)(*a*)(i)(A)(II) and (B)(II).

Fourth, as noted in the opening commentary to paragraph 95(2)(*a*), the amendments to that paragraph ensure that, throughout subparagraph 95(2)(*a*)(ii), except clauses (D) and (E), the word "income" is replaced with the words "income or loss". For further detail on those amendments and on their coming-into-force provisions, see that commentary.

New subclauses 95(2)(*a*)(ii)(A)(II) and (B)(II) and new clause 95(2)(*a*)(ii)(C) apply to taxation years, of a foreign affiliate of a taxpayer, that end after 1999. These amendments are included in the Global Section 95 Election package described at the beginning of the commentary to section 95.

New clause 95(2)(*a*)(ii)(D) applies to taxation years of a foreign affiliate of a taxpayer, that begin after December 20, 2002. However, where the taxpayer elects in writing and files that election with the Minister of National Revenue on or before the filing-due date for the taxpayer's taxation year that includes the day on which these amendments are assented to, subclauses 95(2)(*a*)(ii)(D)(III) to (V) apply in respect of all foreign affiliates of the taxpayer for taxations years that end after 1994. This set of proposals provides that, notwithstanding subsections 152(4) to (5) of the Act, the Minister of National Revenue can make any assessment of a taxpayer's tax, interest and penalties payable under the Act for any taxation year that is necessary to take such an election into account.

New clause 95(2)(*a*)(ii)(E) applies to taxation years of a foreign affiliate of a taxpayer, that begin after December 20, 2002. This amendment is included in the Global Section 95 Election package described at the beginning of the commentary to section 95.

ITA
95(2)(*a*)(v) and (vi)

New subparagraph 95(2)(*a*)(v) of the Act ensures that, in computing the active business income or loss of a particular foreign affiliate, there is to be included the income or loss from property derived by the particular foreign affiliate from the disposition of excluded property that is not capital property of the particular foreign affiliate.

The amendment is consequential to the amendments made to the definition "excluded property" in subsection 95(1).

New subparagraph 95(2)(*a*)(vi) of the Act ensures an income or a loss is treated as active business income or loss (and not as foreign accrual property income or loss) where that income or loss is derived under or as a result of certain agreements which provide for the purchase, sale or exchange of currency and relate to currency exchange risks with respect to amounts included in active business income or loss under paragraph 95(2)(*a*).

New subparagraphs 95(2)(*a*)(v) and (vi) apply to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002. These subparagraphs are included in the Global Section 95 Election package described at the beginning of the commentary to section 95.

ITA
95(2)(*a*.1)(i)

Paragraph 95(2)(*a*.1) of the Act includes in the income from a business other than an active business (and thus the foreign accrual property income (FAPI) of a foreign affiliate) of a taxpayer resident in Canada, the income of the affiliate from the sale of property (including the income derived from services as agent provided in relation to a purchase or sale of property) if

- it is reasonable to conclude that the cost to any person of the property (other than property that was manufactured, produced, grown, extracted or processed in Canada by the taxpayer or a person with which the taxpayer does not deal at arm's length in the course of carrying on a business in Canada and that was subsequently sold to non-resident persons other than the affiliate or to the affiliate for sale to non-resident persons) is relevant in computing the income from a business carried on by the taxpayer or a person resident in Canada that does not deal at arm's length with the taxpayer or is relevant in computing the income from a business carried on in Canada by a non-resident person with whom the taxpayer does not deal at arm's length (subparagraph 95(2)(*a*.1)(i)), and

- the property was not manufactured, produced, grown, extracted or processed in the country under whose laws the affiliate was formed (or continued) and exists and is governed, and the affiliate's business was principally carried on in that country (subparagraph 95(2)(*a*.1)(ii)).

The rule does not apply where more than 90% of the gross income of the affiliate from the sale of property is derived from sales of

property (other than property that falls within the exclusions described above) to persons that deal at arm's length with the affiliate, which, for this purpose, includes a sale of property to a related non-resident corporation for sale by it to arm's length persons. Where the rule applies to the foreign affiliate of the taxpayer, the selling of the property is deemed to be a separate business other than an active business of the affiliate. Any income that pertains to or is incident to that business is also deemed to be income of the affiliate from a business other than an active business of the affiliate.

Subparagraph 95(2)(*a*.1)(i) is amended to replace the description of the property that is excluded from the application of that subparagraph with a new description for that property. Under the new description, property will qualify for the exclusion if it is "designated property" and was subsequently sold to non-resident persons other than the affiliate or to the affiliate for sale to non-resident persons.

The definition "designated property" is provided in new subsection 95(3.1). Property is designated property if it is property that is described in the "preamble" of paragraph 95(2)(*a*.1) and that meets one of the three tests set out in paragraphs (*a*), (*b*) and (*c*), respectively, of that definition.

Under the first test (paragraph (*a*) of the definition), property is designated property if it is

- property that was - in the course of carrying on a business in Canada - manufactured, produced, grown, extracted or processed in Canada by the taxpayer, or by a person with whom the taxpayer does not deal at arm's length, or

- property that was - in the course of a business carried on by a foreign affiliate of the taxpayer outside Canada - manufactured or processed from tangible property that, at the time of the manufacturing or processing, was owned by the taxpayer or by a person related to the taxpayer and used or held by the owner in the course of carrying on a business in Canada, if the manufacturing or processing was in accordance with the specifications of the owner of the tangible property and under a contract between that owner and the foreign affiliate.

Under the second test (paragraph (*b*) of the definition), property is designated property if it was acquired, in the course of carrying on a business in Canada, by a purchaser from a vendor if

- the purchaser is the taxpayer or is a person resident in Canada with whom the taxpayer does not deal at arm's length, and

- the vendor is a person
  - with whom the taxpayer deals at arm's length,
  - who is not a foreign affiliate of the taxpayer, and
  - who is not a foreign affiliate of a person resident in Canada with whom the taxpayer does not deal at arm's length.

Under the third test (paragraph (*c*) of the definition), property is designated property if it was acquired by a purchaser from a vendor if

- the purchaser is the taxpayer or is a person resident in Canada with whom the taxpayer does not deal at arm's length,
- the vendor is a foreign affiliate of
  - the taxpayer, or
  - a person resident in Canada with whom the taxpayer does not deal at arm's length, and
- the property was manufactured, produced, grown, extracted or processed in the country under whose laws the vendor is governed and any of exists, was (unless the vendor was continued in any jurisdiction) formed or organized, or was last continued, and in which the vendor's business is principally carried on.

The amendment to subparagraph 95(2)(*a*.1)(i) applies to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002. Where the taxpayer elects in writing and files that election with the Minister of National Revenue on or before the filing-due date for the taxpayer's taxation year in which these amendments are assented to, new subparagraph 95(2)(*a*.1)(i) and the new definition "designated property" in new subsection 95(3.1) of the Act apply in respect of all foreign affiliates of the taxpayer for taxations years that end after 1994.

***Example 1***

*Facts:*

1. *Canco is a corporation resident in Canada.*
2. *Forco is a controlled foreign affiliate of Canco.*
3. *XYZ is a corporation resident in Canada with whom Canco deals at arm's length.*

4. *Forco sells property to arm's length purchasers situated outside Canada. All the gross revenue and income of Forco is derived from the sale of property acquired from Canco. That property was acquired by Canco from XYZ and was manufactured in Canada by XYZ.*

*Application of paragraph 95(2)(a.1)*

*Forco's income from the sale of the property that Forco had acquired from Canco would, because of existing paragraph 95(2)(a.1), be included in Forco's income from a business other than an active business and thus the FAPI of Forco. This is because existing subparagraph 95(2)(a.1)(i) exempts property manufactured in Canada only if it was manufactured by Canco or by a person with whom the Canco does not deal at arm's length. In this case, the manufacturer is XYZ, an arm's length corporation.*

*However, because of amended subparagraph 95(2)(a.1)(i) and paragraph (b) of the definition "designated property" in new subsection 95(3.1), Forco's income from the sale of the property acquired by Forco from Canco will not be recharacterized by paragraph 95(2)(a.1) as income from a business other than an active business.*

***Example 2***

*Facts:*

1. *Canco is a corporation resident in Canada.*

2. *FA1 is a controlled foreign affiliate of Canco that was formed, exists and is governed under the laws of foreign Country A. FA1's manufacturing business is principally carried on in that country. The gross revenue and income of FA1 is derived from the sale, to Canco, of the property that FA1 manufactures.*

3. *FA2 is a controlled foreign affiliate of Canco. FA2 was formed, exists and is governed under the laws of foreign Country B. FA2's business is principally carried on in that country. FA2 purchases, from Canco, property that was manufactured in Country A by FA1. FA2 sells the property to purchasers outside of Canada.*

*Application of paragraph 95(2)(a.1)*

*The income from the sale of the property acquired by FA2 from Canco would, because of existing paragraph 95(2)(a.1), be included in FA2's income from a business other than an active business and*

*thus the FAPI of FA2. This is because existing subparagraph 95(2)(a.1)(i) exempts property manufactured, produced, grown, extracted or processed in Canada only where the property was manufactured, produced, grown, extracted or processed in Canada by Canco, or by a person with whom Canco does not deal at arm's length. In this case, the property was manufactured outside of Canada by FA1.*

*However, because of amended subparagraph 95(2)(a.1)(i) and paragraph (c) of the definition of "designated property" in new subsection 95(3.1), FA2's income from the sale of the property acquired by FA2 from Canco will not be recharacterized by paragraph 95(2)(a.1) as income from a business other than an active business.*

ITA
95(2)(*b*)

Paragraph 95(2)(*b*) of the Act provides that if, in any of the specified circumstances referred to in that paragraph, a particular controlled foreign affiliate of a taxpayer provides services (or an undertaking to provide services), the provision of those services (or the undertaking) is deemed to be a separate business, other than an active business, carried on by the particular affiliate and any income from that business or that pertains to or is incident to that business is deemed to be income from a business other than an active business. Such income is therefore included in computing the particular affiliate's foreign accrual property income (FAPI).

The "preamble" of paragraph 95(2)(*b*) is amended to provide that if, in any of the circumstances referred to in that paragraph, any particular foreign affiliate of a taxpayer (whether or not that affiliate is a controlled foreign affiliate of the taxpayer) provides services (or an undertaking to provide services), the provision of those services (or the undertaking) is deemed to be a separate business, other than an active business, carried on by the particular affiliate and any income from that business or that pertains to or is incident to that business is deemed to be income from a business other than an active business.

Paragraph 95(2)(*b*) is amended in three ways.

First, clauses (A) and (B) of subparagraph 95(2)(*b*)(i) are replaced by new clause (A). That new clause ensures that income will be considered to be income from an business other than an active business of a foreign affiliate of a taxpayer, if the amount paid or payable in consideration for those services (or the undertaking to provide those services) is deductible, or can reasonably be considered

to relate to an amount that is deductible, in computing the income from a business carried on in Canada, by

- any taxpayer of whom the affiliate is a foreign affiliate, or

- another taxpayer who does not deal at arm's length with any taxpayer of whom the affiliate is a foreign affiliate.

Second, a new clause (B) is added to subparagraph 95(2)(*b*)(i). That new clause ensures that, if a particular foreign affiliate of a taxpayer provides services (or an undertaking to provide services) and the amount paid or payable in consideration for those services (or the undertaking) is deductible, or can reasonably be considered to relate to an amount that is deductible, in computing the FAPI of a foreign affiliate of any taxpayer of whom the particular affiliate is a foreign affiliate or in computing the FAPI of a foreign affiliate of another taxpayer who does not deal at arm's length with any taxpayer of whom the affiliate is a foreign affiliate,

- the provision of those services (or the undertaking) is deemed to be a separate business, other than an active business, carried on by the particular affiliate, and

- any income from that business or that pertains to or is incident to that business is included in computing the particular affiliate's FAPI.

For example, new clause 95(2)(*b*)(i)(B) provides that, within a corporate group, income that would otherwise be income from an investment business (and therefore included in computing FAPI) of one foreign corporation in the group cannot be converted to active business income by the payment of fees to another foreign corporation in the group for services rendered to that investment business.

Third, subparagraph 95(2)(*b*)(ii) is amended to ensure that, if a particular foreign affiliate of a taxpayer provides services (or an undertaking to provide services) and those services are, or are to be, performed by a described party,

- the provision of those services (or the undertaking) is deemed to be a separate business, other than an active business, carried on by the particular affiliate, and

- any income from that business or that pertains to or is incident to that business is included in computing the particular affiliate's FAPI.

A described party is

- the taxpayer,

- a person resident in Canada with whom the taxpayer does not deal at arm's length,

- a partnership any member of which is a person described above, or

- a partnership in which any person or partnership described above has, directly or indirectly, a partnership interest.

These amendments to paragraph 95(2)(*b*) apply to taxation years of a foreign affiliate of a taxpayer that begin after December 20, 2002 except that, in applying paragraph 95(2)(*b*) to a foreign affiliate of the taxpayer for taxation years of the foreign affiliate that begin after December 20, 2002 and on or before Announcement Date, that paragraph is to be read as follows:

> "*(b) the provision, by a foreign affiliate of a taxpayer, of services or of an undertaking to provide services is deemed to be a separate business, other than an active business, carried on by the affiliate, and any income from that business or that pertains to or is incident to that business is deemed to be income from a business other than an active business, if*
>
> > *(i) the amount paid or payable in consideration for those services or for the undertaking to provide those services*
> >
> > > *(A) is deductible, or can reasonably be considered to relate to an amount that is deductible, in computing the income from a business carried on in Canada, by*
> > >
> > > > *(I) any taxpayer of whom the affiliate is a controlled foreign affiliate, or*
> > > >
> > > > *(II) another person who is related to any taxpayer of whom the affiliate is a controlled foreign affiliate, or*
> > >
> > > *(B) is deductible, or can reasonably be considered to relate to an amount that is deductible, in computing the foreign accrual property income of a controlled foreign affiliate of*
> > >
> > > > *(I) any taxpayer of whom the affiliate is a controlled foreign affiliate, or*
> > > >
> > > > *(II) another person who is related to any taxpayer of whom the affiliate is a controlled foreign affiliate, or*

*(ii) the services are, or are to be, performed by*

*(A) any taxpayer of whom the affiliate is a controlled foreign affiliate and who is an individual resident in Canada, or*

*(B) another person who is related to any taxpayer of whom the affiliate is a controlled foreign affiliate and who is an individual resident in Canada;"*

ITA
95(2)(*c*.1) to (*c*.6)

New paragraphs 95(2)(*c*.1) to (*c*.6) of the Act put into place a regime that, in general terms, is intended to suspend the recognition of the capital gain that would have arisen upon an internal disposition by a foreign affiliate of a corporation resident in Canada (or a partnership of which the foreign affiliate is a member) of a share of another foreign affiliate of a corporation resident in Canada that is excluded property to the vendor (or would be excluded property to the vendor if the vendor were a foreign affiliate of the taxpayer) if such a disposition would otherwise result in a gain. Generally, this "suspended gain" is recognized when there is an external disposition of the share. See the definitions "specified vendor" and "specified purchaser" in proposed new subsection 95(3.2) to determine when a disposition of a share of the capital stock of a foreign affiliate of a corporation resident in Canada is an internal disposition. These provisions replace proposed subsections 93(1.4) to (1.6) of the Act that were found in the December 20, 2002 proposals.

New paragraphs 95(2)(*c*.1) to (*c*.6) will apply to dispositions that occur after December 20, 2002. However, those paragraphs will not apply to a disposition of a share of the capital stock of a foreign affiliate of a corporation resident in Canada by a vendor

- if the disposition of the share is required to be made under an agreement in writing made by the vendor on or before December 20, 2002, or

- if the disposition of the share occurs on or before Announcement Date and a valid election in respect of the vendor is made under subsection 133(40) of the enacting legislation.

Where such an election is made, the special rules set out under subsection 133(40) of the enacting legislation will apply. Generally, a modified version of the proposed subsections 93(1.4) to (1.6) that were part of the December 20, 2002 proposals will apply. For details about the election and about those special rules, see the draft enacting

legislation that this commentary accompanies. Note also that this current set of proposals provides that, notwithstanding subsections 152(4) to (5) of the Act, the Minister of National Revenue can make any assessment of a taxpayer's tax, interest and penalties payable under the Act for any taxation year that is necessary to take such an election into account.

ITA
95(2)(*c*.1)

New paragraph 95(2)(*c*.1) of the Act sets out the circumstances under which new paragraph 95(2)(*c*.2) will apply. Generally, new paragraph 95(2)(*c*.2) applies to a specified vendor (defined in new subsection 95(3.2)), in respect of a corporation resident in Canada, if:

- the specified vendor disposes of, at any time, a share of the capital stock of a foreign affiliate of the corporation resident in Canada, (referred to here as the "specified share", and which time is referred to here as the "original disposition time" of the specified share and which foreign affiliate is referred to here as the "disposed foreign affiliate") to a person or partnership that is, immediately after that time, a specified purchaser (defined in new subsection 95(3.2)) in respect of the corporation resident in Canada);

- immediately before the original disposition time, the specified share is excluded property of the specified vendor (or would be excluded property of the specified vendor if the specified vendor were, immediately before the original disposition time, a foreign affiliate of the corporation resident in Canada);

- if the Act were read without reference to paragraph 95(2)(*c*.2), the specified vendor would have a taxable capital gain from the disposition of the specified share; and

- none of paragraphs 88(3)(*a*) and 95(2)(*c*), (*d*) to (*e*.1) and (*e*.3) to (*e*.5) applies to the specified vendor in respect of the disposition of the share.

ITA
95(2)(*c*.2)

New paragraph 95(2)(*c*.2) of the Act sets out various rules that will apply to the specified vendor and the specified purchaser in respect of the corporation resident in Canada. The rules can be summarized as follows:

- Where the specified vendor is not a partnership, the proceeds of disposition (determined without reference to subsection 93(1)) from the disposition of the specified share (referred to in new subsection 95(2)(*c*.1)) are deemed to be an amount equal to one of the following two amounts:

  - the total of the specified vendor's adjusted cost base of the specified share and the amount, if any, that would be designated under subsection 93(1) because of subsection 93(1.1) in respect of the specified share if the specified share was disposed of for consideration equal to its fair market value at the original disposition time (referred to in new subsection 95(2)(*c*.1)) of the specified share (such aggregate referred to here as the "specified amount"), or

  - if the specified vendor is a controlled foreign affiliate of the particular corporation resident in Canada at the end of the specified vendor's taxation year that includes the original disposition time of the specified share and the particular corporation elects in prescribed manner and within the prescribed time (see proposed new section 5915 of the Regulations), the greater of the specified amount and the amount that is the lesser of the fair market value of the consideration received by the specified vendor in respect of the disposition and the amount that the particular corporation designates in the election.

- Where the specified vendor is a partnership of which a particular foreign affiliate of the particular corporation referred to in the definition "specified vendor" in new subsection 95(3.2) is a member, in computing the particular foreign affiliate's taxable capital gain from the disposition by the partnership of the specified share, the specified vendor's proceeds of disposition from the disposition of the specified share are deemed to be an amount that is equal to one of the following amounts:

  - the total of the specified vendor's adjusted cost base of the specified share and the amount of a dividend, if any, that would be deemed by subsection 93(1.2) to have been received immediately before the original disposition time because of subsection 93(1.3) in respect of the specified share in respect of the particular foreign affiliate on the assumptions that the specified share is a share referred to in subsection 93(1.3) in respect of the particular foreign affiliate, no other share of the disposed foreign affiliate was disposed of at the original disposition time of the specified share, the particular foreign affiliate was the only member of the partnership, and the specified share was disposed of for consideration equal to its

fair market value at the original disposition time of the specified share (referred to here as the "clause (A) amount"), or

- if the particular foreign affiliate is a controlled foreign affiliate of the particular corporation resident in Canada at the end of the particular foreign affiliate's taxation year that includes the original disposition time of the specified share and the particular corporation elects in prescribed manner and within the prescribed time (see proposed section 5915 of the Regulations), the greater of the Clause (A) amount and the amount that is the lesser of the fair market value of the consideration received by the vendor in respect of the disposition and the amount that the particular corporation designates in the election.

- The specified purchaser's cost of the specified share is deemed to be the fair market value at the original disposition time of the specified share.

- The specified vendor's cost of property received as consideration for the disposition of the specified share is deemed to be the fair market value of the property at the original disposition time of the specified share.

- The specified vendor that is a foreign affiliate of the particular corporation resident in Canada or a foreign affiliate of the particular corporation resident in Canada that is a member of a partnership that is the specified vendor (here and in the commentary to paragraph 95(2)(*c*.3) referred to as the "relevant foreign affiliate") is deemed to have an unadjusted suspended gain in respect of a specified share disposed of, at the original disposition time, by the specified vendor that is equal to twice the amount, if any, by which

  - the amount of the taxable capital gain that, but for the application of this paragraph, would have been realized by the relevant foreign affiliate in respect of that disposition, if the specified vendor's proceeds of disposition in respect of that disposition were equal to the fair market value of the consideration received by the specified vendor in respect of the disposition,

  exceeds

  - the amount of the taxable capital gain that was realized by the relevant foreign affiliate in respect of that disposition.

ITA
95(2)(*c*.3)

New subsection 95(2)(*c*.3) of the Act deems the specified vendor referred to in paragraph 95(2)(*c*.1) to have a capital gain from the disposition of the specified share (defined in new paragraph 95(2)(*c*.1)) equal to the amount of the adjusted suspended gain (see new section 5912 of the Regulations) in respect of the specified share and to have paid to the government of a country an amount equal to the adjusted allocable tax (see new section 5912 of the Regulations) in respect of the adjusted suspended gain at the earlier of

- the first time, after the original disposition time (defined in new paragraph 95(2)(*c*.1)), that a specified purchaser (defined in new subsection 95(3.2)) in respect of the particular corporation that holds, immediately before that first time, the specified share makes a triggering disposition (defined in new subsection 95(3.3)) of the specified share; and

- the first time, after the original disposition time, that a specified purchaser (the "current holder") in respect of the particular corporation that holds, immediately before that first time, the specified share ceases to be a specified purchaser in respect of the particular corporation otherwise than because of a specified discontinuance (defined in new subsection 95(3.2)) of the current holder.

ITA
95(2)(*c*.4)

New paragraph 95(2)(*c*.4) of the Act provides, for the purpose of paragraph 95(2)(*c*.3), that - if a specified purchaser (defined in new subsection 95(3.2) and referred to here as a "current holder") in respect of a corporation resident in Canada holds the specified share (defined in paragraph 95(2)(*c*.1)) and that share is redeemed, acquired or cancelled (otherwise than on a "dividend-like redemption" of that share defined in new subsection 95(3.2)) by the disposed foreign affiliate (defined in new paragraph 95(2)(*c*.1)) - the specified share is deemed to continue to exist, and the current holder is deemed to continue to hold the share, until the time that the current holder ceases to be a specified purchaser in respect of the corporation resident in Canada otherwise than because of a specified discontinuance (defined in new subsection 95(3.3)) of the current holder.

ITA
95(2)(*c*.5)

New paragraph 95(2)(*c*.5) of the Act provides, for the purpose of paragraph 95(2)(*c*.3), that - if a specified purchaser (defined in new subsection 95(3.2) and referred to here as a "current holder") in respect of a corporation resident in Canada holds a specified share (described in new paragraph 95(2)(*c*.1)) in respect of the corporation resident in Canada and the specified share ceases to exist as a result of a dissolution, winding-up, cessation of existence, merger or combination described in paragraph (*a*) or (*b*) of the definition "specified discontinuance" in subsection 95(3.3) or subparagraph (*a*)(i) or (ii) of the definition "triggering disposition" in subsection 95(3.3) - the specified share is deemed to continue to exist, and the current holder is deemed to continue to hold the share, until the current holder ceases to be a specified purchaser in respect of the corporation resident in Canada otherwise than because of a specified discontinuance of the current holder.

ITA
95(2)(*c*.6)

New paragraph 95(2)(*c*.6) of the Act provides, for the purpose of paragraph 95(2)(*c*.3), that if a specified share (described in new paragraph 95(2)(*c*.1)) in respect of a corporation resident in Canada is exchanged for another share of the disposed foreign affiliate (described in new paragraph 95(2)(*c*.1)) the other share is deemed to be the specified share in respect of the corporation resident in Canada.

ITA
95(2)(*d*)

Paragraph 95(2)(*d*) of the Act provides rules that apply to a foreign affiliate of a taxpayer that is a shareholder of another foreign affiliate (a "predecessor foreign affiliate") of the taxpayer that participates in a foreign merger and that shareholder receives shares of a new foreign corporation formed on the foreign merger or the foreign parent corporation, as the case may be, in exchange for its shares in the predecessor foreign affiliate.

Paragraph 95(2)(*d*) is amended to provide the following rules in cases where there has been a foreign merger (other than a foreign merger to which proposed paragraph 95(2)(*d*.1) applies) of two or more predecessor foreign corporations to form a new foreign corporation that was, immediately after the foreign merger, a foreign affiliate of a corporation resident in Canada, and a particular foreign predecessor

corporation to the foreign merger was, immediately before the foreign merger, a foreign affiliate of the corporation resident in Canada.

- each property of the particular foreign predecessor corporation that became property of the new foreign corporation as a result of the foreign merger is deemed to have been disposed by the particular foreign predecessor corporation to the new foreign corporation for proceeds of disposition equal to

  - if the property is excluded property of the particular foreign predecessor corporation immediately before the foreign merger, an amount that is equal to the relevant cost base, immediately before the foreign merger, of the property to the particular foreign predecessor corporation, or

  - in any other case, an amount equal to the fair market value, immediately before the foreign merger, of the property,

- the cost of the property to the new foreign corporation, immediately after the foreign merger, is deemed to be equal to the amount so determined to be the particular foreign predecessor corporation's proceeds of disposition of the property,

- each shareholder of the particular foreign predecessor corporation that was, immediately before the foreign merger, a specified vendor in respect of the corporation resident in Canada

  - is deemed to have disposed, on the foreign merger, of each share of the particular foreign predecessor corporation that, immediately before the foreign merger, was held by the shareholder and was excluded property of the shareholder, for proceeds of disposition that are equal to such amount as the corporation resident in Canada elects, in prescribed manner and within the prescribed time (see proposed section 5916 of the Regulations), in respect of the share, that is not less than the adjusted cost base, immediately before the foreign merger, of the share, to the shareholder and is not more than the fair market value, immediately before the foreign merger, of the share,

  - is deemed to have acquired each particular share of the new foreign corporation received on the foreign merger by the shareholder in exchange for a share described in clause (A) for a cost equal to the amount determined by the formula

$$A \times B / C$$

where

A is the total of all amounts each of which is the proceeds of disposition of a share of the predecessor determined above,

B is the fair market value, immediately after the foreign merger, of the particular share of the new foreign corporation, and

C is the fair market value, immediately after the foreign merger, of all shares of the new foreign corporation received on the foreign merger by the shareholder,

- the new foreign corporation is deemed to be the same person as, and a continuation of, the particular foreign predecessor corporation
  - for the purposes of paragraphs 95(2)(*c*.1) to (*c*.6), in respect of the disposition of a specified share received on the foreign merger by the new foreign corporation and disposed of, on the foreign merger, to the new foreign corporation by the particular foreign predecessor corporation,
  - for the purposes of paragraphs 95(2)(*f*.3) to (*f*.93), in respect of the disposition of a specified property received on the foreign merger by the new foreign corporation and disposed of, on the foreign merger, to the new foreign corporation by the particular foreign predecessor corporation, and
  - for the purposes of paragraphs 95(2)(h*) to (*h.5*), in respect of the disposition of a specified property received on the foreign merger by the new foreign corporation and disposed of, on the foreign merger, to the new foreign corporation by the particular foreign predecessor corporation,*
- the taxation year of the particular predecessor foreign corporation that would otherwise include the time of the foreign merger is deemed to have ended immediately before that time, and
- where the fair market value of the share of the predecessor corporation exchanged by the shareholder on the foreign merger exceeds the fair market value of the share of the new foreign corporation received on the foreign merger for the exchanged share and it is reasonable to consider all or any portion of the excess as a benefit that the shareholder desired to have conferred on another shareholder of the new foreign corporation, the amount of the benefit

- is deemed to be income from property that is the shares of the new foreign corporation of the other shareholder, and

- is to be added to the adjusted cost base of the shares of the new foreign corporation of the other shareholder if they are excluded property.

New paragraph 95(2)(*d*) applies to foreign mergers that occur after Announcement Date.

ITA
95(2)(*d*.1)

Paragraph 95(2)(*d*.1) of the Act provides for the rollover of capital property on a foreign merger where certain conditions have been met. One of these conditions (referred to as the "non-recognition condition") is that no gain or loss was recognized, under the income tax law of the country in which the predecessor foreign corporations were resident, in respect of any capital property of a predecessor foreign corporation that became capital property of the new foreign corporation in the course of the foreign merger.

Paragraph 95(2)(*d*.1) is amended in a number of ways.

First, paragraph 95(2)(*d*.1) is amended to provide for the rollover of property (including, but not restricted to capital property) on a foreign merger where certain conditions have been met. In addition, the non-recognition condition is amended to require that no income, gain or loss was recognized, under the income tax law of the country in which the predecessor foreign corporations were resident, in respect of any property of a predecessor foreign corporation that became property of the new foreign corporation in the course of the foreign merger.

Second, the amendments to subparagraph 95(2)(*d*.1)(ii) treat (for the purposes of paragraphs 95(2)(*c*.1) to (*c*.6), (*f*.1) to (*f*.93) and (*h*) to (*h*.5)) the new foreign corporation as the same corporation as and as a continuation of the predecessor foreign corporation.

Third, new subparagraph 95(2)(*d*.1)(iv) is a consequential to the amendments to paragraph 95(2)(*d*) and makes subsection 87(4) applicable to the shareholders of the predecessor foreign corporation that are foreign affiliates of the corporation resident in Canada.

The amendments to paragraph 95(2)(*d*.1) apply to foreign mergers that occur after December 20, 2002.

ITA
95(2)(*e*)

Paragraph 95(2)(*e*) of the Act provides rules for determining foreign accrual property income that apply when a foreign affiliate of a taxpayer dissolves and, on the dissolution, disposes of shares of a foreign affiliate of the taxpayer a to another foreign affiliate of the taxpayer.

Paragraph 95(2)(*e*) is amended to provide for the following rules if, at a particular time, a shareholder (other than a person resident in Canada) of a foreign affiliate (referred to in this paragraph as the "disposed foreign affiliate") of a particular corporation resident in Canada that is a specified purchaser in respect of the particular corporation receives, in the course of a liquidation and dissolution (other than a liquidation and dissolution to which paragraph 95(2)(*e*.1) applies) of the disposed foreign affiliate, a property from the disposed foreign affiliate:

- the disposed foreign affiliate's proceeds of disposition of the property are deemed to be
  - if the property is excluded property of the disposed foreign affiliate at the particular time, an amount that is equal to the relevant cost base (defined in current subsection 95(4)), immediately before the particular time, of the property to the disposed foreign affiliate, or
  - in any other case, an amount equal to the fair market value, immediately before the particular time, of the property,
- the cost of the property to the shareholder immediately after the particular time is deemed to be an amount equal to the disposed foreign affiliate's proceeds of disposition of the property determined above,
- the property is deemed to have been received by the shareholder as proceeds of disposition of shares of the disposed foreign affiliate disposed of by the shareholder in the course of the liquidation and dissolution,
- each particular share of the disposed foreign affiliate disposed of by the shareholder in the course of the liquidation and dissolution is deemed to have been disposed of for proceeds that are equal to the amount determined by the formula

$$(A - B) \times C/D$$

where

A is the total of all amounts each of which is the cost to the shareholder, immediately after the particular time, of a property received by the shareholder as consideration for the disposition of the shares of the disposed foreign affiliate disposed of in the course of the liquidation and dissolution,

B is the total of all amounts each of which is the amount of a debt that was owing by the disposed foreign affiliate, or any other obligation of the disposed foreign affiliate to pay an amount that was outstanding, immediately before it was assumed or cancelled, as the case may be, by the shareholder,

C is the fair market value, immediately before the commencement of the liquidation and dissolution, of the particular share, and

D is the fair market value, immediately before the commencement of the liquidation and dissolution, of all the shares of the disposed foreign affiliate disposed of by that shareholder,

- any gain from the disposition of the shares of the disposed foreign affiliate disposed of by the shareholder in the course of the liquidation and dissolution that, but for this subparagraph, would be a gain from the disposition of excluded property of the shareholder, is deemed to be the lesser of
  - the amount of the gain as otherwise determined, and
  - such amount, not exceeding the amount of the gain as otherwise determined, as the particular corporation resident in Canada elects in prescribed manner and within the prescribed time (see proposed new section 5916 of the Regulations), and
- the shareholder is deemed to be the same person as, and a continuation of, the disposed foreign affiliate
  - for the purposes of paragraphs 95(2)(*c*.1) to (*c*.6), in respect of the disposition of a specified share received by the shareholder and disposed of, to the shareholder, by the disposed foreign affiliate in the course of the liquidation and dissolution,
  - for the purposes of paragraphs 95(2)(*f*.3) to (*f*.93), in respect of the disposition of a specified property received by the shareholder and disposed of, to the shareholder, by the disposed

foreign affiliate in the course of the liquidation and dissolution, and

- for the purposes of paragraphs 95(2)(*h*) to (*h*.5), in respect of the disposition of a specified property received by the shareholder and disposed of, to the shareholder, by the disposed foreign affiliate in the course of the liquidation and dissolution, and

• the taxation year of the disposed foreign affiliate that would otherwise include the time that the disposed foreign affiliate is dissolved is deemed to have ended immediately before that time.

A “specified purchaser” in respect of a corporation resident in Canada is defined in proposed new subsection 95(3.2) of the Act.

The amendments to paragraph 95(2)(*e*) apply to liquidations that begin after Announcement Date.

ITA
95(2)(*e*.1)

Paragraph 95(2)(*e*.1) of the Act provides for the rollover of capital property on a liquidation and a dissolution of a foreign affiliate of a taxpayer where certain conditions have been met. One of these conditions (referred to as the “non-recognition condition”) is that no gain or loss was recognized, under the income tax law of the country in which the disposing affiliate was resident, by the disposing affiliate in respect of any property of the disposing affiliate that was distributed by the disposing affiliate in the course of the liquidation to another foreign affiliate, of the taxpayer, resident in that country.

Paragraph 95(2)(*e*.1) is amended in the following ways.

First, paragraph 95(2)(*e*.1) is amended to provide for the rollover of property (including, but not restricted to, capital property) on a liquidation and a dissolution of a foreign affiliate of a taxpayer where certain conditions have been met.

Second, the non-recognition condition in paragraph 95(2)(*e*.1) is amended to require that no income, gain or loss was recognized, under the income tax law of the country in which the disposing affiliate was resident, by the disposing affiliate in respect of any property of the disposing affiliate that was distributed by the disposing affiliate in the course of the liquidation and dissolution to another foreign affiliate of the taxpayer. The non-recognition condition no longer requires that this other foreign affiliate be resident in the same country as the disposing affiliate.

Third, the amendments to subparagraph 95(2)(e.1)(ii) treat (for the purposes of paragraphs 95(2)(*c*.1) to (*c*.6), (*f*.1) to (*f*.93) and (*h*) to (*h*.5)) the shareholder of the disposing affiliate as the same corporation as the disposing affiliate.

New paragraph 95(2)(*e*.1) applies to liquidations that begin after December 20, 2002.

ITA
95(2)(*e*.2)

New paragraph 95(2)(*e*.2) of the Act provides that, for the purpose of new paragraph 95(2)(*e*.1), a redemption, acquisition or cancellation of the shares of a foreign affiliate of a corporation resident in Canada will be treated as a liquidation and a dissolution of the foreign affiliate if:

- the surplus entitlement percentage of the corporation resident in Canada, in respect of the foreign affiliate, immediately before the redemption, acquisition or cancellation is more than 90%, and the surplus entitlement percentage of the corporation resident in Canada, in respect of the foreign affiliate is, immediately after the redemption, acquisition or cancellation, nil, and the foreign affiliate has no issued and outstanding shares immediately after the redemption, acquisition or cancellation; or

- in the course of the redemption, acquisition or cancellation, property having a fair market value equal to or greater than 90% of the fair market value, immediately before the redemption, acquisition or cancellation, of the property owned by the foreign affiliate is, because of the redemption, acquisition or cancellation, distributed to the shareholders of the foreign affiliate.

New paragraph 95(2)(*e*.2) applies to redemptions, acquisitions or cancellations that occur after Announcement Date other than a redemption, an acquisition or a cancellation of shares of a holder of shares that are required to be made under an agreement in writing made by the holder on or before Announcement Date.

ITA
95(2)(*e*.3) to (*e*.6)

New paragraphs 95(2)(*e*.3) to (*e*.6) of the Act put into place a regime that, in general terms, is intended to provide to a foreign affiliate of a corporation resident in Canada the possibility of rollover treatment (and avoidance of gains that will be included in foreign accrual property income) for dispositions of excluded property of the foreign affiliate to a specified purchaser in respect of the corporation resident

in Canada. A "specified purchaser" in respect of a corporation resident in Canada is defined in proposed new subsection 95(3.2) of the Act.

Paragraphs 95(2)(*e*.3) to (*e*.6) apply to a receipt, after Announcement Date, by a specified purchaser in respect of the corporation resident in Canada from a foreign affiliate of the corporation resident in Canada of property as a dividend or distribution in respect of a share of the foreign affiliate, or as consideration in respect of a redemption, purchase or acquisition of a share of the foreign affiliate. The paragraphs do not apply where the property was received because of a legal obligation of the foreign affiliate that arose on or before Announcement Date to pay the dividend or make the distribution, redemption, purchase or acquisition.

ITA
95(2)(*e*.3)

New paragraph 95(2)(*e*.3) of the Act provides for the following rules (notwithstanding subsection 52(2)), if, at a particular time, a shareholder (other than a person resident in Canada), of a foreign affiliate of a corporation resident in Canada, that is a specified purchaser (defined in new subsection 95(3.2)) in respect of the corporation resident in Canada receives (otherwise than in the course of a liquidation and dissolution of the foreign affiliate or a merger or combination of corporations involving the foreign affiliate) a property from the foreign affiliate as a dividend or distribution on a share of the foreign affiliate.

- The foreign affiliate's proceeds of disposition of the property are deemed to be:

  - if the property is excluded property of the foreign affiliate at the particular time, an amount that is equal to the relevant cost base (defined in subsection 95(4) of the Act) of the property to the foreign affiliate immediately before the particular time; or

  - in any other case, an amount that is equal to the fair market value, immediately before the particular time, of the property.

- The cost of the property to the shareholder, immediately after the particular time, is deemed to be an amount equal to the foreign affiliate's proceeds of disposition of the property determined above.

- The amount of that dividend or distribution, in respect of the property, is deemed to be equal to the foreign affiliate's proceeds of disposition of the property determined above.

- Where, but for subparagraph 95(2)(*e*.3)(iv) (the provision described by this paragraph), the shareholder would, because of subsection 40(3), have a gain in respect of the share of the foreign affiliate on or in respect of which the dividend or distribution was received and the share of the foreign affiliate is excluded property of the shareholder (or would be excluded property of the shareholder if the shareholder were a foreign affiliate of the particular corporation), for the purposes of applying subsection 40(3), the amount prescribed by paragraph 5900(1)(*c*) of the Regulations to have been paid out of the pre-acquisition surplus of the particular foreign corporation's foreign affiliate from which the property was received, otherwise determined, in respect of the dividend or distribution in respect of the share shall be deemed to be the lesser of:

  - the amount that, if subparagraph 95(2)(*e*.3)(iv) did not exist, would be so prescribed; and

  - the amount - not exceeding the amount that would, if subparagraph 95(2)(*e*.3)(iv) did not exist, be so prescribed - that the particular corporation elects in prescribed manner and within the prescribed time (see proposed new section 5916 of the Regulations).

ITA
95(2)(*e*.4)

New subparagraph 95(2)(*e*.4) of the Act provides for the following rules if, at a particular time, a shareholder (other than a person resident in Canada), of a foreign affiliate of a corporation resident in Canada, that is a specified purchaser in respect of the corporation resident in Canada, receives (otherwise than in the course of the liquidation and dissolution of the foreign affiliate or a merger or combination of corporations that includes the foreign affiliate) a property from the foreign affiliate as consideration in respect of a dividend-like redemption (defined in subsection 95(3.2)) of a share of the foreign affiliate by the foreign affiliate.

- The foreign affiliate's proceeds of disposition of the property are deemed to be

  - where the property is excluded property of the foreign affiliate at the particular time, an amount that is equal to the relevant cost base (defined in subsection 95(4) of the Act) of the property to the foreign affiliate immediately before the particular time, or

- in any other case, an amount equal to the fair market value, immediately before the particular time, of the property.

- The cost of the property immediately after the particular time to the shareholder is deemed to be an amount equal to the amount of the foreign affiliate's proceeds of disposition of the property determined above.

- The property is deemed to have been received by the shareholder as a dividend on the share and the amount of that dividend, in respect of the property, is deemed to be equal to the amount of the foreign affiliate's proceeds of disposition of the property determined above.

- Where the share of the foreign affiliate redeemed is excluded property of the shareholder (or would be excluded property of the shareholder if the shareholder were a foreign affiliate of the particular corporation), the shareholder is deemed to have disposed of the share for proceeds of disposition equal to the cost amount of the share to the shareholder immediately before the disposition.

- Where, but for subparagraph 95(2)(*e*.4)(v) (the provision described by this paragraph), the shareholder would, because of subsection 40(3), have a gain in respect of the share of the foreign affiliate because of the dividend received by the shareholder in respect of the redemption of the share, for the purposes of applying subsection 40(3), the amount prescribed by paragraph 5900(1)(*c*) of the Regulations to have been paid out of the pre-acquisition surplus of the foreign affiliate - of the corporation resident in Canada - from which the property was received, otherwise determined, in respect of the deemed dividend described above in respect of the share is deemed to be the lesser of

    - the amount that, but for subparagraph 95(2)(*e*.4)(v), would be so prescribed, and

    - the amount - not exceeding the amount that, but for subparagraph 95(2)(*e*.4)(v), would be so prescribed - that the corporation resident in Canada elects in prescribed manner and within the prescribed time (see proposed new subsection 5916 of the Regulations).

ITA
95(2)(*e*.5)

New paragraph 95(2)(*e*.5) of the Act provides the following rules if, at a particular time, a shareholder (other than a person resident in Canada), of a foreign affiliate of a corporation resident in Canada,

that is a specified purchaser (defined in new paragraph 95(3.2)) in respect of the corporation resident in Canada receives (otherwise than in the course of a dividend-like redemption (defined in subsection 95(3.2)), a liquidation and dissolution of the foreign affiliate, or a merger or combination of corporations that includes the foreign affiliate) a property from the foreign affiliate as consideration in respect of a redemption, acquisition or cancellation (the "particular redemption") of a particular share of the foreign affiliate by the foreign affiliate as part of a redemption, acquisition or cancellation (the "total redemption") of one or more shares (including the particular share) of the foreign affiliate held by the shareholder.

- The foreign affiliate's proceeds of disposition of the property are deemed to be:

  - if the property is excluded property of the foreign affiliate at the particular time, an amount that is equal to the relevant cost base (defined in subsection 95(4)), immediately before the particular time, of the property to the foreign affiliate; or

  - in any other case, an amount that is equal to the fair market value, immediately before the particular time, of the property.

- The cost of the property to the shareholder immediately after the particular time is deemed to be the foreign affiliate's proceeds of disposition of the property. (Subparagraph 95(2)(*e*.5)(ii))

- The property is deemed to have been received by the shareholder as proceeds of disposition of shares of the foreign affiliate disposed of by the shareholder in the course of the particular redemption.

- The particular share disposed of to the foreign affiliate because of the particular redemption is deemed to have been disposed of for proceeds that are equal to the amount determined by the formula

$$(A - B) \times C/D$$

  where

  A is the total of all amounts each of which is the cost, determined in subparagraph 95(2)(*e*.5)(ii), to the shareholder, of a property received by the shareholder as consideration for the disposition by the shareholder of a share or shares of the foreign affiliate redeemed in the course of the total redemption;

  B is the total of all amounts each of which the amount of a debt that was owing by the foreign affiliate, or any other obligation of the foreign affiliate to pay an amount that was outstanding,

immediately before it was assumed or cancelled by the shareholder in respect of the total redemption;

C is

- if the particular share was held by the shareholder at the time immediately before the commencement of the total redemption, the fair market value, at that time, of the particular share; and

- if the particular share was acquired by the shareholder after the commencement of the total redemption, the fair market value, at the time of its acquisition, of the particular share.

D is the total of

- the fair market value, immediately before the commencement of the total redemption, of all shares of the foreign affiliate held by the shareholder before the commencement of the total redemption and redeemed as part of the total redemption while held by the shareholder; and

- the total of all amounts each of which is the fair market value at the time of acquisition of a share of the foreign affiliate acquired after the commencement of the total redemption by the shareholder and redeemed as part of the total redemption while held by the shareholder.

• Any gain from the disposition of a particular share of the foreign affiliate disposed of by the shareholder in the course of the total redemption that, but for subparagraph 95(2)(*e*.5)(v) (the provision described by this bullet), would be a gain from the disposition of excluded property of the shareholder, is deemed to be the lesser of:

  - the amount of the gain as otherwise determined; and

  - such amount, not exceeding the amount of the gain as otherwise determined, as the corporation resident in Canada elects in prescribed manner and within the prescribed time (see proposed section 5916 of the Regulations).

ITA
95(2)(*e*.6)

New paragraph 95(2)(*e*.6) of the Act provides the following rules, for the purposes of applying paragraphs 95(2)(*e*) and (*e*.3) to (*e*.5) for the purposes of determining a foreign affiliate's income from the partnership, if the shareholder of the foreign affiliate of the corporation resident in Canada referred to in those paragraphs is the

partnership and the foreign affiliate of the corporation resident in Canada is a member of the partnership.

- Shares of a foreign affiliate of the corporation resident in Canada referred to in those paragraphs that are property of the partnership, or are deemed under paragraph 95(2)(*e*.6) to be property of the partnership, are deemed to be owned at that time by each member of the partnership in a proportion equal to the proportion of the shares that:

  - the fair market value at that time of the member's partnership interest in the partnership

  is of

  - the fair market value at that time of all members' partnership interests in the partnership.

- Each amount determined under any of paragraphs 95(2)(*e*) and (*e*.3) to (*e*.5) in respect of the partnership in respect of the shares of the foreign affiliate deemed above to be owned by a member of the partnership that is a foreign affiliate of the corporation resident in Canada is deemed to be the amount determined under that paragraph in respect of the member in respect of those shares.

- The income, gain or loss derived by the partnership, while a foreign affiliate of the corporation resident in Canada is a member of the partnership, in respect of the shares deemed above to be owned by the foreign affiliate

  - is to be determined as if the partnership were the foreign affiliate, and

  - is deemed to be an income or a loss or a taxable capital gain or an allowable capital loss, as the case may be, of the foreign affiliate from the partnership and not to be an income or a loss or a taxable capital gain or an allowable capital loss of any other member of the partnership.

ITA
95(2)(*f*)

Paragraph 95(2)(*f*) of the Act sets out rules for computing a taxable capital gain and an allowable capital loss of a foreign affiliate of a taxpayer resident in Canada from a disposition of a property. The rules in paragraph 95(2)(*f*) address the computation of a gain or loss from a disposition of property whether the disposition is made by the

foreign affiliate itself or by a partnership of which the foreign affiliate is a member.

That paragraph also provides a relieving provision (contained in that portion of that paragraph that is between subparagraphs (ii) and (iii)) that provides that, in computing any such gain or loss from the disposition of property that was owned by the foreign affiliate at the last time that the foreign affiliate became a foreign affiliate of the taxpayer resident in Canada, there is not to be included such portion of the gain or loss, as the case may be, as can reasonably be considered to have accrued during the period that the foreign affiliate was not a foreign affiliate of the taxpayer resident in Canada or of a person specified in any of subparagraphs 95(2)(*f*)(iv) to (vii).

Paragraph 95(2)(*f*) is amended in the following ways:

- The "preamble" of paragraph 95(2)(*f*) is amended to clarify that the rules in that paragraph apply in respect of the taxpayer in computing the foreign affiliate's capital gains and capital losses from a disposition of property by the affiliate or a partnership. This amendment to paragraph 95(2)(*f*) will, for example, preclude the recognition of capital gains or capital losses from the disposition of property by a foreign affiliate or a partnership to the extent that the gain or loss can reasonably be considered to have accrued during the period that the affiliate was not a foreign affiliate of the taxpayer or a person or partnership specified in paragraph 95(2)(*f*). This is relevant for the purpose of computing the tax surpluses and deficits of the affiliate in respect of the taxpayer and computing the affiliate's foreign accrual property income or loss of the affiliate in respect of the taxpayer.

- Subparagraph 95(2)(*f*)(*i*) is amended to add references to new paragraphs 95(2)(*c*.2), (*d*.1), (*e*.3) to (*e*.5) and (*f*.4). For information about those paragraphs, see the commentaries for those paragraphs.

- The "mid-amble" of paragraph 95(2)(*f*) is amended to replace the words "owned by the affiliate" with the words "owned by the person or partnership". This amendment addresses situations where the property disposed of was owned by a partnership of which the foreign affiliate of the taxpayer is a member. This amendment also ensures that, in computing a gain or loss from the disposition of property, no portion of the gain or loss, as the case may be, that can reasonably be considered to have accrued during the period that the affiliate was not a foreign affiliate of the taxpayer or of a person specified in subparagraphs 95(2)(*f*)(iv) to (viii) is included.

- The "mid-amble" of paragraph 95(2)(*f*) is further amended to delete the words "at the time it last became a foreign affiliate of the taxpayer". This requirement was unnecessary for the operation of paragraph 95(2)(*f*).

- New subparagraph 95(2)(*f*)(viii) is added to include, in the listed parties, a partnership, where the total of all amounts each of which is the fair market value of a partnership interest in the partnership owned by a person described in any of subparagraphs 95(2)(*f*)(iii) to (vii) is greater than or equal to 90% of the fair market value of all partnership interests in the partnership.

The amendments to the "preamble" of paragraph 95(2)(*f*) apply to taxation years, of a foreign affiliate of a taxpayer, that end after 1999.

The amendment to subparagraph 95(2)(*f*)(i) applies to taxation years, of a foreign affiliate of a taxpayer, that end after December 20, 2002.

The amendment to the "mid-amble" of paragraph 95(2)(*f*) applies to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002. However, see the commentary to new subsection 95(2.2) for details of an election to apply the amendments to the "mid-amble" of paragraph 95(2)(*f*) to taxation years, of all foreign affiliates of the taxpayer, that begin after 1994. Note also that the amendments to the "mid-amble" of the paragraph 95(2)(*f*) are part of the Global Section 95 Election package described at the beginning of the commentary to section 95.

The enactment of new subparagraph 95(2)(*f*)(viii) applies to taxation years, of a foreign affiliate of a taxpayer, that begin after Announcement Date.

ITA
95(2)(*f*.1)

New paragraph 95(2)(*f*.1) of the Act provides rules that apply in computing the income or loss of a foreign affiliate of a taxpayer from property, or the income or loss from a business other than an active business of a foreign affiliate of a taxpayer resident in Canada, in respect of the taxpayer. The rules can be summarized as follows:

- the income or loss is computed in respect of the taxpayer in Canadian currency, as though the foreign affiliate were resident in Canada and as though the Act were read without reference to subsections 14(1.01) to (1.03), 17(1) and 18(4) and section 91, and

- the income or loss is to be computed as if it does not include any income or loss that can reasonably be considered to have been

realized or to have accrued during any period throughout which the affiliate was not a foreign affiliate of the taxpayer or of another person or partnership described in any of subparagraphs 95(2)(*f*)(iii) to (viii).

Related rules can be found in proposed new paragraphs 95(2)(*f*.91) to (*f*.93).

For details about new amended subsection 14(1.01) and new subsections 14(1.02) and (1.03), see the commentary to those subsections.

New paragraph 95(2)(*f*.1) applies to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002, except that for those taxation years that begin on or before Announcement Date, subparagraph 95(2)(*f*.1)(iv) is to be read as follows:

*"(iv) there were not included in computing the income or loss the portion of the income or loss that can reasonably be considered to have been realized or to have accrued during any period throughout which the affiliate was not a foreign affiliate of the taxpayer or of a person described in any of subparagraphs (f)(iii) to (vii);"*

Note that new paragraph 95(2)(*f*.1) is part of the Global Section 95 Election package described at the beginning of the commentary to section 95.

ITA
95(2)(*f*.2)

New paragraph 95(2)(*f*.2) of the Act provides that the income or loss of a foreign affiliate of a taxpayer arising from the disposition of excluded property which is not capital property (other than a disposition of property to which any of paragraphs 95(2)(*d*) to (*e*.1), (*e*.3) to (*e*.5) and (*f*.4) and 88(3)(*a*) of the Act applies) is to be computed in respect of the taxpayer in the currency of the country in which the foreign affiliate is resident or in another currency that is reasonable in the circumstances. (The expression "excluded property" is defined in subsection 95(1).) The calculations provided for in new paragraph 95(2)(*f*.2) are comparable to those provided for in the rule in subsection 5907(6) of the Regulations.

New subparagraph 95(2)(*f*.2) applies to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002. Note that new paragraph 95(2)(*f*.2) is part of the Global Section 95 Election package described at the beginning of the commentary to section 95.

ITA
95(2)(*f*.3) to (*f*.9)

New paragraphs 95(2)(*f*.3) to (*f*.9) of the Act put into place a regime that, in general terms, is designed to suspend the recognition of the income or capital gain that would otherwise arisen upon an internal disposition of an excluded property. Generally, this "suspended gain" is recognized at the time the property is disposed of in an external disposition. This regime replaces the rules found in existing subsection 5907(5.1) of the Regulations and the rules found in proposed subsections 5907(5.1) to (5.3) of the Regulations that were part of the December 20, 2002 proposals.

New paragraphs 95(2)(*f*.3) to (*f*.9) will apply to dispositions of property that occur after Announcement Date. However, those paragraphs will not apply to a disposition by a vendor that is required to be made under an agreement in writing made by the vendor on or before Announcement Date.

ITA
95(2)(*f*.3)

New paragraph 95(2)(*f*.3) of the Act provides the circumstances under which new paragraph 95(2)(*f*.4) applies to a specified vendor (defined in new subsection 95(3.2)) in respect of a particular corporation resident in Canada if the following conditions are met:

- the specified vendor disposes at any time of a property that, at that time, is excluded property of the vendor (or would be excluded property of the vendor if the vendor were, at that time, a foreign affiliate of the particular corporation) to a person or partnership that is, immediately after that time, a specified purchaser (defined in new subsection 95(3.2)) in respect of the particular corporation, and

- if this Act were read without reference to paragraph 95(2)(*f*.4), the specified vendor would have income or a taxable capital gain from the disposition of the property.

In new paragraphs 95(2)(*f*.4) and (*f*.5) and (*f*.7) to (*f*.9), the specified vendor is referred to as the "vendor", the time of the disposition of the excluded property is referred to as the "original disposition time" and the property is referred to as the "specified property".

ITA
95(2)(*f*.4)

New paragraph 95(2)(*f*.4) of the Act sets out rules that apply to a vendor and a purchaser in respect of a particular disposition of specified property referred to in new paragraph 95(2)(*f*.3). In new paragraph 95(2)(*f*.4), the specified vendor is referred to as the "vendor", the time of the disposition of the excluded property is referred to as the "original disposition time" and the property is referred to as the "specified property". The rules can be summarized as follows:

- The vendor's proceeds from the disposition of the specified property are deemed to be equal to the vendor's adjusted cost base of the specified property at the original disposition time (referred to in here in this commentary as the "relevant ACB amount") or, if the vendor that is a foreign affiliate of the particular corporation resident in Canada is a controlled foreign affiliate of the particular corporation resident in Canada at the end of that vendor's taxation year that includes the original disposition time of the specified property and the particular corporation resident in Canada so elects in prescribed manner and within the prescribed time (see proposed new section 5916 of the Regulations), the proceeds from the disposition of the property can be equal to an amount greater than the relevant ACB amount, but cannot exceed the fair market value of the specified property at the original disposition time.

- The cost to the purchaser of the specified property is deemed to be equal to the fair market value of the specified property at the original disposition time.

- The cost to the vendor of a particular property that was received as consideration for the disposition of the specified property is deemed to be the fair market value of the particular property at the original disposition time.

- The foreign affiliate of the particular corporation resident in Canada that is the vendor or that is a member of a partnership that is the vendor (which foreign affiliate is referred to in subparagraph 95(2)(*f*.4)(iv) and in paragraph 95(2)(*f*.5) as the "relevant foreign affiliate") is deemed to have an unadjusted suspended income or gain in respect of a specified property disposed of, at the original disposition time, equal to the amount, if any, by which

  - the amount that is the income or twice the amount of the taxable capital gain, as the case may be, that, but for the application of this paragraph, would have been realized by the relevant foreign affiliate in respect of that disposition,

exceeds

- the amount that is the income or twice the amount of the taxable capital gain, as the case may be, that was realized by the relevant foreign affiliate in respect of that disposition.

ITA
95(2)(*f*.5)

New paragraph 95(2)(*f*.5) of the Act deems the relevant foreign affiliate referred to in subparagraph 95(2)(*f*.4)(iv) to have income or a taxable capital gain from the disposition of the specified property equal to the amount prescribed to be the adjusted suspended income or gain (see proposed new subsection 5913(1) of the Regulations) in respect of the specified property and to have paid to the government of a country an amount equal to the amount prescribed by regulation to be the adjusted allocable tax (see proposed new subsection 5913(2) of the Regulations) in respect of the adjusted suspended income or gain in respect of the specified property at the earlier of

- the first time, after the original disposition time, that a specified purchaser in respect of the particular corporation that holds, immediately before that first time, the specified property and makes a triggering disposition (see definition in subsection 95(3.4)) of the specified property, or

- the first time, after the original disposition time, that a specified purchaser in respect of the particular corporation (which specified purchaser is referred to here and in paragraphs 95(2)(*f*.8) and (*f*.9) as the "current holder") that holds, immediately before that first time, the specified property, and ceases, at that first time, to be a specified purchaser in respect of the particular corporation otherwise than because of a specified discontinuance of the current holder.

ITA
95(2)(*f*.6)

New paragraph 95(2)(*f*.6) of the Act ensures that paragraph 95(2)(*f*.3) will not apply to a disposition of a property by a person or partnership if

- any of subsections 85.1(5) and 88(3) and paragraphs 95(2)(*c*), (*c*.2), (*d*), (*d*.1), (*e*), (*e*.1), (*e*.3), (*e*.4) and (*e*.5) applies to the person or partnership in respect of the disposition of the property, or

- the property was disposed of in the ordinary course of an active business of the person or partnership or was disposed of as an adventure or concern in the nature of trade.

ITA
95(2)(*f*.7)

New paragraph 95(2)(*f*.7) of the Act provides that for the purposes of paragraphs 95(2)(*f*.3) to (*f*.6) and (*f*.8) and (*f*.9) and subsection 95(3.4), a designated replacement property referred to in clause (*b*)(ii)(A), (B) or (C) of the definition "triggering disposition" in new subsection 95(3.4) is deemed to be the same property as the specified property referred to in that clause.

ITA
95(2)(*f*.8)

New paragraph 95(2)(*f*.8) of the Act provides that for the purposes of paragraph 95(2)(*f*.3) to (*f*.7) and (*f*.9) and subsection 95(3.4), where, at any time, part of a specified property (referred to here as the "initial specified property") is disposed of by a current holder (defined in new paragraph 95(2)(*f*.5)) and the remaining part of the specified property is retained by the current holder, the following rules apply:

- The part (referred to here as the "part interest") of the initial specified property disposed of, at that time, is deemed to be a specified property of the current holder.

- The portion of the unadjusted suspended income or gain attributable to the part interest is deemed to be that proportion of the adjusted suspended income or gain in respect of the whole of the initial specified property that the fair market value at that time of the part interest is of the fair market value at that time of the initial specified property.

- The part (referred to here as the "remaining interest") of the initial specified property not disposed of at that time is deemed to be a specified property of the current holder that was disposed of at the original disposition time.

- The amount of income or gain that would have been realized on the disposition of the remaining interest at the original disposition time is deemed to be the amount, if any, by which the unadjusted suspended income or gain in respect of the initial specified property exceeds the amount determined to be the unadjusted suspended income or gain in respect of the part interest.

ITA
95(2)(*f*.9)

New paragraph 95(2)(*f*.9) of the Act provides that for the purposes of paragraphs 95(2)(*f*.3) to (*f*.8), if a current holder (defined in new paragraph 95(2)(*f*.5)) disposes, at any particular time, of the whole of a specified property (referred to here as the "initial specified property") and as part of a transaction, or series of transactions or events, that includes the disposition of the initial specified property, a specified purchaser (defined in new subsection 95(3.2)) in respect of the particular corporation acquires a designated replacement property (referred to here as the "remaining interest") in respect of the initial specified property, the following rules apply:

- The remaining interest is deemed to be a specified property of the current holder that was disposed of at the original disposition time. (Subparagraph 95(2)(*f*.9)(i))

- The unadjusted suspended income or gain in respect of the remaining interest is deemed to be that portion of the unadjusted suspended income or gain in respect of the whole of the initial specified property (determined without reference to subparagraph 95(2)(*f*.9)(iii)) that the fair market value of the remaining interest, at the time it was acquired, is of the fair market value, at the particular time, of the initial specified property. (Subparagraph 95(2)(*f*.9)(ii))

- The unadjusted suspended income or gain in respect of the initial specified property is deemed to be the amount, if any, by which the unadjusted suspended income or gain in respect of the initial specified property (determined without reference to subparagraph 95(2)(*f*.9)(iii)) exceeds the amount determined by subparagraph 95(2)(*f*.9)(ii) to be the unadjusted suspended income or gain in respect of the remaining interest. (Subparagraph 95(2)(*f*.9)(iii))

ITA
95(2)(*f*.91) to (*f*.93)

In general terms, new paragraphs 95(2)(*f*.91) to (*f*.93) of the Act introduce rules relating to the determination of the cost of eligible capital property, and the capital cost and the undepreciated capital cost of depreciable capital property, of a non-resident corporation that becomes a foreign affiliate of a taxpayer resident in Canada for the purposes of computing the foreign affiliate's foreign accrual property income in respect of the taxpayer resident in Canada or in respect of a specified party in respect of the taxpayer resident in Canada. These rules complement the rules in new paragraph 95(2)(*f*.2) and are comparable to but not the same as the rules, in existing subsections

111(5.1) and (5.2) of the Act, that apply when control of a corporation has been acquired.

ITA
95(2)(*f*.91)

New paragraph 95(2)(*f*.91) of the Act provides certain additional rules for computing the foreign accrual property income of a foreign affiliate of a taxpayer in respect of the taxpayer.

New paragraph 95(2)(*f*.91) applies if, at a particular time, a non-resident corporation that, immediately before the particular time, was not a foreign affiliate of a particular taxpayer resident in Canada, or of a person or partnership that would - if the particular taxpayer were a taxpayer referred to in paragraphs 95(2)(*f*)(iii) to (viii) - be described by any of those subparagraphs (the particular taxpayer or each of those persons or partnerships being referred to in this paragraph and new paragraphs 95(2)(*f*.92), (*f*.93) and (*f*.94) as a "particular Canadian shareholder") becomes a foreign affiliate of the particular Canadian shareholder.

The non-resident corporation is referred to in this paragraph and paragraph 95(2)(*f*.92) as a "particular foreign affiliate" in respect of the particular Canadian shareholder. The particular time is referred to in this paragraph and in paragraph 95(2)(*f*.92) as the "status change time" in respect of the particular foreign affiliate of the particular Canadian shareholder.

New paragraph 95(2)(*f*.91) provides rules that apply in computing the particular foreign affiliate's foreign accrual property income in respect of the particular Canadian shareholder or a person or partnership that would - if the person or partnership were a taxpayer referred to in subparagraphs 95(2)(*f*)(iii) to (viii) - be described by any of those subparagraphs (the particular Canadian shareholder or each of those persons or partnerships being referred to in paragraph 95(2)(*f*.92) as a "relevant shareholder") for any taxation year of the particular foreign affiliate that ends after the status change time.

Those rules can be summarized as follows:

- For the purpose of determining the cumulative eligible capital of the particular foreign affiliate in respect of the particular Canadian shareholder, at the beginning of the particular foreign affiliate's taxation year that includes the status change time, in respect of each business (other than an active business) carried on by the particular foreign affiliate in that taxation year, the particular affiliate is deemed to have disposed, immediately before the beginning of that taxation year, of each "eligible property" (see

third paragraph, below) of the particular foreign affiliate, at the time of that disposition, in respect of each business (other than an active business) carried on by the particular foreign affiliate at the time of that disposition, for proceeds equal to the cost to the particular foreign affiliate of the eligible property at the time of that disposition.

- For the purpose of determining the cost of eligible property to the particular foreign affiliate in respect of the particular Canadian shareholder, and the cumulative eligible capital of the particular foreign affiliate in respect of the particular Canadian shareholder, for its taxation year that includes the status change time in respect of the particular foreign affiliate in respect of the particular Canadian shareholder and for each subsequent taxation year, in respect of each business (other than an active business) of the particular foreign affiliate in that taxation year or subsequent taxation year, the particular foreign affiliate is deemed to have acquired, immediately after the beginning of its particular taxation year that includes the status change time in respect of the particular foreign affiliate in respect of the particular Canadian shareholder, each eligible property of the particular foreign affiliate, immediately before the beginning of the particular year, in respect of each business carried on by the particular foreign affiliate that is, immediately before the beginning of the particular year, a business (other than an active business) of the particular foreign affiliate, at a cost equal to the lesser of

    - the fair market value of the eligible property at the status change time, and

    - the cost to the particular foreign affiliate of the eligible property immediately before the beginning of the particular year.

- "Eligible property" in respect of a business carried on by the particular foreign affiliate is a property, right or thing in respect of which the particular foreign affiliate has, after 1971 and before the status change time, made an eligible capital expenditure in respect of the business.

- For the purpose of determining, at the beginning of the particular foreign affiliate's taxation year that includes the status change time in respect of the foreign affiliate in respect of the particular Canadian shareholder, the undepreciated capital cost to the particular foreign affiliate of a depreciable capital property used or held by the particular foreign affiliate in the course of carrying on a business other than an active business of the particular foreign affiliate in that taxation year,

- the particular foreign affiliate is deemed to have disposed, immediately before the beginning of that taxation year, of each depreciable capital property of the particular foreign affiliate, held by the particular foreign affiliate and used or held in the course of carrying on a business of the particular foreign affiliate that is a business (other than an active business) immediately before the beginning of that taxation year, for proceeds equal to the capital cost to the particular foreign affiliate of the depreciable property at the beginning of that year, and

- at the time that is immediately after the time of that disposition, the particular foreign affiliate's undepreciated capital cost of its depreciable capital property, in respect of each such business that is a business other than an active business, is deemed to be nil.

• For the purpose of determining the capital cost and undepreciated capital cost to the particular foreign affiliate in respect of the particular Canadian shareholder of its depreciable capital property used or held in the course of carrying on each business (other than an active business) carried on by the particular foreign affiliate, for the particular foreign affiliate's taxation year that includes the status change time in respect of the particular foreign affiliate in respect of the particular Canadian shareholder and for its subsequent taxation years, the particular foreign affiliate is deemed to have acquired, at the time that is immediately after the beginning of its taxation year that includes the status change time, each depreciable capital property (each such depreciable capital property referred to in this subparagraph and paragraph 95(2)(*f*.93) as a "specified depreciable property") that was owned by the particular foreign affiliate and used or held by the particular foreign affiliate, immediately before the beginning of the foreign affiliate's taxation year that includes the status change time, in the course of carrying on a business of the particular foreign affiliate other than an active business, at a capital cost equal to the lesser of

  - the fair market value of the specified depreciable property at the status change time, and

  - the capital cost to the particular foreign affiliate of the specified depreciable property immediately before the beginning of the foreign affiliate's taxation year that includes the status change time.

New paragraph 95(2)(*f*.91) applies in respect of non-resident corporations that become foreign affiliates of a particular taxpayer resident in Canada after Announcement Date.

ITA
95(2)(*f*.92)

New paragraph 95(2)(*f*.92) of the Act is consequential to new paragraph 95(2)(*f*.91). It provides that, in applying paragraph (*a*) of the description of E in the definition "cumulative eligible capital" in subsection 14(5) in respect of a particular disposition that occurs after the beginning of the taxation year of a the particular foreign affiliate that includes the status change time (defined in paragraph 95(2)(*f*.91)) in respect of the particular foreign affiliate in respect of the particular Canadian shareholder, (defined in paragraph 95(2)(*f*.91)), by the particular foreign affiliate (defined in paragraph 95(2)(*f*.91)) of a relevant shareholder (defined in paragraph 95(2)(*f*.91)), in respect of which a particular consideration (that was eligible property defined in paragraph 95(2)(*f*.91) that was in existence at the time immediately before the status change time was provided by the particular foreign affiliate, the particular foreign affiliate's proceeds from the particular disposition, are deemed to be the amount, if any, determined by the formula

$$A - (B + C)$$

where

A is the particular foreign affiliate's proceeds from the particular disposition, as otherwise determined,

B is the lesser of

- the amount, if any, by which
  - the fair market value, of the eligible property, immediately before the status change time in respect of the particular Canadian shareholder

  exceeds

  - the particular foreign affiliate's cost, of the eligible property, immediately before the particular disposition, and
- the amount, if any, by which the particular foreign affiliate's proceeds from the particular disposition, as otherwise determined, exceeds the particular foreign affiliate's cost of the

eligible property, immediately before the particular disposition, and

C is the lesser of

- the amount, if any, by which

  - the particular foreign affiliate's cost, of the eligible property, immediately before the beginning of the taxation year of the particular foreign affiliate that included the status change time in respect of the particular Canadian shareholder

  exceeds

  - the fair market value, of the eligible property, immediately before the status change time in respect of the particular Canadian shareholder, and

- the amount, if any, by which the particular foreign affiliate's proceeds from the particular disposition, as otherwise determined, exceeds the particular foreign affiliate's cost of the eligible property, immediately before the disposition.

New paragraph 95(2)(*f*.92) applies in respect of non-resident corporations that become foreign affiliates after Announcement Date.

ITA
95(2)(*f*.93)

New paragraph 95(2)(*f*.93) of the Act is consequential to new paragraph 95(2)(*f*.91). It provides that if, at any time after the beginning of the taxation year of the particular foreign affiliate (defined in paragraph 95(2)(*f*.91)) that includes the status change time (defined in paragraph 95(2)(*f*.91)) in respect of the particular foreign affiliate in respect of the particular Canadian shareholder (defined in paragraph 95(2)(*f*.91)), the particular foreign affiliate disposes of a particular specified depreciable property (defined in paragraph 95(2)(*f*.91)), the particular foreign affiliate's proceeds from the disposition of the particular specified depreciable property are deemed to be the amount, if any, determined by the formula

$$A - (B + C)$$

where

A is the particular foreign affiliate's proceeds of disposition in respect of the disposition of the particular specified depreciable property, as otherwise determined,

B is the lesser of

- the amount, if any, by which

  - the fair market value, of the particular specified depreciable property, immediately before the status change time in respect of the particular Canadian shareholder

  exceeds

  - the particular foreign affiliate's capital cost of the particular specified depreciable property, immediately before the disposition, and

- the amount, if any, by which the particular foreign affiliate's proceeds from the disposition of the particular specified depreciable property, as otherwise determined, exceed the particular foreign affiliate's capital cost of the particular specified depreciable property immediately before the time of the disposition, and

C is the lesser of

- the amount, if any, by which

  - the particular foreign affiliate's capital cost of the particular specified depreciable property immediately before the beginning of the taxation year of the particular foreign affiliate that includes the status change time in respect of the particular Canadian shareholder

  exceeds

  - the fair market value of the particular specified depreciable property at the time immediately before the status change time in respect of the particular Canadian shareholder, and

- the amount, if any, by which the particular foreign affiliate's proceeds from the disposition of the particular specified depreciable property, as otherwise determined, exceed the particular foreign affiliate's capital cost of the particular specified depreciable property, immediately before the disposition.

New paragraph 95(2)(*f*.93) applies in respect of non-resident corporations that become foreign affiliates after Announcement Date.

ITA
95(2)(*f*.94)

New paragraph 95(2)(*f*.94) of the Act provides that, for the purposes of paragraphs 95(2)(*f*.5) and (*f*.91) to (*f*.93), if the relevant foreign affiliate referred to in paragraph 95(2)(*f*.5) or the particular foreign affiliate referred to in any of paragraphs 95(2)(*f*.91) to (*f*.93) (in either case, the "specified foreign affiliate") has been wound up into another non-resident corporation (the "foreign parent corporation") or merged or combined with one or more other non-resident corporations to form one non-resident corporate entity (the "new foreign corporation"), the foreign parent corporation or the new foreign corporation, as the case may be, is deemed to be the same corporation as and a continuation of the specified foreign affiliate, if

- the surplus entitlement percentage of the particular corporation resident in Canada, immediately before the merger or combination or the winding-up, in respect of the specified foreign affiliate is not less than 90%, and

- the surplus entitlement percentage of the particular corporation resident in Canada, immediately after the merger or combination or the winding-up, in respect of the foreign parent corporation or new foreign corporation, as the case may be, is not less than 90%.

New paragraph 95(2)(*f*.94) applies after Announcement Date.

ITA
95(2)(*g*)

Paragraph 95(2)(*g*) of the Act provides that where, because of a fluctuation in the value of the currency of a country other than Canada relative to the value of Canadian currency, a foreign affiliate of a taxpayer in respect of which the taxpayer has a qualifying interest throughout a taxation year of the affiliate has earned income or incurred a loss or realized a capital gain or a capital loss in the year, in reference to certain debt and share transactions of the affiliate, the income, gain or loss, as the case may be, is nil.

Paragraph 95(2)(g) is amended to expand its scope of application to not only foreign affiliates of a taxpayer in respect of which the taxpayer has a qualifying interest throughout the taxation year, but also to foreign affiliates to which the taxpayer is related throughout the taxation year.

The amendment to paragraph 95(2)(*g*) applies to taxation years of a foreign affiliate of a taxpayer that begin after December 20, 2002.

Note that this amendment is part of the Global Section 95 Election package described at the beginning of the commentary to section 95.

ITA
95(2)(*g*.01)

New paragraph 95(2)(*g*.01) of the Act deals with foreign currency hedging agreements. In general terms, that paragraph provides that a foreign currency income, gain or loss derived under or as a result of an agreement that provides for the purchase, sale or exchange of currency where the agreement can reasonably be considered to have been made by a foreign affiliate of a taxpayer to reduce the affiliate's risk (with respect to any source, any particular income, gain or loss determined in reference to which is deemed by paragraph 95(2)(*g*) to be nil) of fluctuations in the value of currency is, to the extent of the absolute value of the particular income, gain or loss, deemed to be nil. This amendment ensures that income, a gain or a loss from a hedge is deemed to be nil if the hedged income, loss or gain is deemed to be nil.

New paragraph 95(2)(*g*.01) applies to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002. Note that new paragraph 95(2)(*g*.01) is part of the Global Section 95 Election package described at the beginning of the commentary to section 95.

ITA
95(2)(*g*.02)

New paragraph 95(2)(*g*.02) of the Act ensures that foreign exchange gains and losses of a foreign affiliate of a taxpayer determined under subsection 39(2) in respect of excluded property (as defined in subsection 95(1) of the Act) are computed separately from the affiliate's foreign exchange gains and losses in respect of other property. This amendment facilitates the computation of the foreign accrual property income and the tax surpluses and deficits of a foreign affiliate of a taxpayer.

New paragraph 95(2)(*g*.02) applies to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002. Note that new paragraph 95(2)(*g*.02) is part of the Global Section 95 Election package described at the beginning of the commentary to section 95.

ITA
95(2)(*h*) to (*h*.5)

New paragraphs 95(2)(*h*) to (*h*.5) of the Act put into place a regime that, in general terms, is designed to suspend the recognition of the loss that would otherwise be incurred upon an internal disposition of

a property that is not an excluded property, a depreciable property or an eligible capital property. Generally, this "suspended loss" is recognized at the time the property is disposed of in an external disposition. The rules are comparable to but not the same as the rules found in subsection 40(3.4) of the Act. See the definitions "specified vendor" and "specified purchaser" in proposed new subsection 95(3.5) to determine when a disposition is an internal disposition.

New paragraphs 95(2)(*h*) to (*h*.5) apply to dispositions of property after Announcement Date other than where the disposition of property is required to be made under a written agreement made by the vendor of the property on or before Announcement Date.

ITA
95(2)(*h*)

New paragraph 95(2)(*h*) of the Act provides that new paragraph 95(2)(*h*.1) applies to a specified vendor in respect of a particular taxpayer resident in Canada (see definition of "specified vendor" in subsection 95(3.5) and such specified vendor referred in here and paragraph (*h*.1) as the "vendor") if

- the vendor disposes at any time (referred to here and in paragraphs 95(2)(*h*.1) to (*h*.5) as the "original disposition time") of a property (referred to here and in paragraphs 95(2)(*h*.1) to (*h*.5) as the "specified property") that, at that time, is not a depreciable property, eligible capital property or an excluded property of the vendor (or would not be excluded property of the vendor if the vendor were, at that time, a foreign affiliate of the particular taxpayer) to a person or partnership (referred to here as the "purchaser") that is, immediately after that time, a specified purchaser in respect of the particular taxpayer, and

- the vendor would have a loss or an allowable capital loss from the disposition of the specified property, if this Act were read without reference to paragraph 95(2)(*h*.1).

The expressions "original disposition time", "specified property", "vendor" and "purchaser" are described in new paragraph 95(2)(*h*) and are then referred to throughout new paragraphs 95(2)(*h*.1) to 95(2)(*h*.5).

ITA
95(2)(*h*.1)

New paragraph 95(2)(*h*.1) of the Act provides the following rules for the vendor in respect of the disposition of the specified property.

- The vendor's proceeds from the disposition of the specified property are deemed to be an amount that is equal to the vendor's adjusted cost base of the specified property at the original disposition time (see paragraph 95(2)(*h*)).

- The purchaser's cost of the specified property is deemed to be an amount that is equal to the fair market value of the specified property at the original disposition time.

- The vendor's cost of a particular property that was received as consideration for the disposition of the specified property is deemed to be the fair market value of the particular property at the original disposition time.

- The vendor that is a foreign affiliate of the particular taxpayer or a foreign affiliate of the particular taxpayer that is a member of a partnership that is the vendor (referred to here as the "relevant foreign affiliate") is deemed to have an unadjusted suspended loss or capital loss in respect of the specified property, at the original disposition time, by the vendor that is equal to the amount, that, but for the application of this paragraph, would have been the relevant foreign affiliate's loss or twice the amount of the allowable capital loss, as the case may be, in respect of that disposition, if the vendor's proceeds of disposition in respect of that disposition were equal to the fair market value of the specified property.

- Notwithstanding subsection 40(3.3), subsection 40(3.4) does not apply to the vendor in respect of the disposition of the specified property.

ITA
95(2)(*h*.2)

New paragraph 95(2)(*h*.2) of the Act provides that the relevant foreign affiliate referred to in paragraph 95(2)(*h*.1) is deemed to have a loss or capital loss from the disposition of the specified property equal to the amount prescribed by regulation to be the adjusted suspended loss or capital loss (see proposed new subsection 5914(1) of the Regulations) in respect of the specified property. New paragraph 95(2)(*h*.2) also provides that the relevant foreign affiliate referred to in paragraph 95(2)(*h*.1) is deemed to have received from

the government of a country an amount equal to the amount prescribed by regulation to be the adjusted allocable tax refund (see proposed new subsection 5914(2) of the Regulations) in respect of the adjusted suspended loss or capital loss in respect of the specified property. The adjusted suspended loss or capital loss and the adjusted allocable tax refund will arise at the earlier of

- the first time, after the original disposition time, that a specified purchaser (see subsection 95(3.5)) in respect of the particular taxpayer (referred to in paragraphs 95(2)(*h*.4) and (*h*.5) as the "current vendor") that holds, immediately before that first time, the specified property makes a triggering disposition (see subsection 95(3.5)) of the specified property.

or

- the first time, after the original disposition time, that a specified purchaser in respect of the particular taxpayer (referred to here as the "current holder") that holds, immediately before that first time, the specified property, ceases at that time to be a specified purchaser in respect of the particular taxpayer otherwise than because of a specified discontinuance (see subsection 95(3.5)) of the current holder.

ITA
95(2)(*h*.3)

New paragraph 95(2)(*h*.3) of the Act provides that for the purposes of paragraphs 95(2)(*h*.1), (*h*.2), (*h*.4) and (*h*.5) and subsection 95(3.5), a designated replacement property referred to in clause (*b*)(ii)(A), (B) or (C) of the definition "triggering disposition" in subsection 95(3.5) is deemed to be the same property as the specified property referred to in that clause.

ITA
95(2)(*h*.4)

New paragraph 95(2)(*h*.4) of the Act provides that for the purposes of paragraphs 95(2)(*h*.1) to (*h*.3) and (*h*.5) and subsection 95(3.5), where at any time, part of a specified property (referred to here as the "initial specified property") is disposed of by a current vendor and the remaining part of the specified property is retained by the current vendor, the following rules apply:

- The part (referred to here as the "part interest") of the initial specified property disposed of, at that time, shall be deemed to be a specified property of the current vendor.

- The portion of the unadjusted suspended loss or capital loss attributable to the part interest is deemed to be that proportion of the adjusted suspended loss or capital loss in respect of the whole of the initial specified property that the fair market value at that time of the part interest is of the fair market value at that time of the initial specified property. (Subparagraph 95(2)(*h*.4)(ii))

- The part (referred to here as the "remaining interest") of the initial specified property not disposed of at that time is deemed to be a specified property of the current vendor that was disposed of at the original disposition time.

- The amount of loss or capital loss that would have been realized on the disposition of the remaining interest at the original disposition time is deemed to be the amount, if any, by which the unadjusted suspended loss or capital loss in respect of the initial specified property exceeds the amount determined by subparagraph 95(2)(*h*.4)(ii) to be the unadjusted suspended loss or capital loss in respect of the part interest.

ITA
95(2)(*h*.5)

New paragraph 95(2)(*h*.5) of the Act provides that for the purposes of paragraphs 95(2)(*h*.1) to (*h*.4) and subsection 95(3.5), if a current vendor disposes, at any particular time, of the whole of a specified property (referred to here as the "initial specified property") and as part of a transaction, or series of transactions or events, that includes the disposition of the initial specified property, a specified purchaser in respect of the taxpayer acquires a designated replacement property (see the definition "triggering disposition" in subsection 95(3.5)) in respect of the initial specified property, the following rules apply:

- The designated replacement property (referred to here as "the remaining interest") is deemed to be a specified property of the current vendor that was disposed of at the original disposition time. (Subparagraph 95(2)(*h*.5)(i))

- The unadjusted suspended loss or capital loss in respect of the remaining interest is deemed to be that portion of the unadjusted suspended loss or capital loss in respect of the whole of the initial specified property (determined without reference to subparagraph 95(2)(*h*.5)(iii)) that the fair market value of the remaining interest, at the time it was acquired, is of the fair market value, at the particular time, of the initial specified property. (Subparagraph 95(2)(*h*.5)(ii))

- The unadjusted suspended loss or capital loss in respect of the initial specified property is deemed to be the amount, if any, by which the unadjusted suspended loss or capital loss in respect of the initial specified property (determined without reference to subparagraph 95(2)(*h*.5)(iii)) minus the amount determined by subparagraph 95(2)(*h*.5)(ii) to be the unadjusted suspended loss or capital loss in respect of the remaining interest. (Subparagraph 95(2)(*h*.5)(iii))

ITA
95(2)(*i*)

Paragraph 95(2)(*i*) of the Act provides a rule under which certain gains or losses (determined in accordance with subsection 39(2) of the Act) of a foreign affiliate of a taxpayer are deemed to be a gain or loss, as the case may be, from the disposition of an excluded property (as defined in subsection 95(1) of the Act) and are therefore not included in computing the affiliate's foreign accrual property income. Under this paragraph, the gain or loss that is eligible for this treatment is a gain or loss of the affiliate from the settlement or extinguishment of a debt that related at all times to the acquisition of an excluded property. This paragraph is amended in three ways.

First, it is amended so that the gain or loss from the settlement or extinguishment of a debt is eligible for this treatment if all or substantially all of the proceeds from the debt were used at all times to acquire excluded property or to earn income from an active business or a combination of those uses.

Second, it is amended to ensure that a gain or loss of a foreign affiliate is also eligible for this treatment if it is a gain or loss derived under or as a result of an agreement that provides for the purchase, sale or exchange of currency, where the agreement can reasonably be considered to have been made by the affiliate to reduce its risk (with respect to the debt) of fluctuations in the value of the currency in which the debt was denominated.

Third, it is amended so that its "preamble" contains a specific reference to gains and losses, determined in accordance with subsection 39(2) of the Act, which provides the general rules for the calculation of foreign currency gains and losses.

These amendments to paragraph 95(2)(*i*) clarify the relationship between paragraph 95(2)(*f*) and subsection 39(2) of the Act and expand the scope of paragraph 95(2)(*i*) so that it applies more broadly to indebtedness used to fund active business operations. It also applies to certain foreign currency hedging agreements that are related to that indebtedness.

These amendments to paragraph 95(2)(*i*) apply to taxation years of a foreign affiliate, of a taxpayer, that begin after December 20, 2002. Note that these amendments are part of the Global Section 95 Election package described at the beginning of the commentary to section 95.

ITA
95(2)(*j*.1) and (*j*.2)

New paragraphs 95(2)(*j*.1) and (*j*.2) of the Act ensure that a foreign affiliate of a taxpayer resident in Canada that carries on an insurance business is eligible to claim certain policy reserves in connection with an insurance business in computing its foreign accrual property income.

New paragraph 95(2)(*j*.1) provides that new paragraph 95(2)(*j*.2) applies in respect of a particular taxation year of a foreign affiliate of a taxpayer and in respect of a particular fiscal period of a partnership at the end of which a foreign affiliate of a taxpayer is a member of the partnership (which foreign affiliate or partnership is referred to as the "operator" and which particular taxation year or particular fiscal period is referred to as the "specified taxation year") if in the specified taxation year

- the operator carries on a business (referred to as a "foreign business"),
- the foreign business includes the insuring of risks,
- the foreign business is not, at any time, a "taxable Canadian business" (as newly defined in subsection 95(1) of the Act),
- the foreign business is
  - an investment business, or
  - a business the activities of which include activities deemed by paragraph 95(2)(*a*.2) or (*b*) to be a separate business, other than an active business, carried on by the affiliate, and
- in respect of the foreign business, the operator would, if it were a corporation carrying on the foreign business in Canada, be required by law to report to, and be subject to the supervision of, a regulatory authority that is the Superintendent of Financial Institutions or a similar authority of a province.

New paragraph 95(2)(*j*.2) provides that in computing an operator's income or loss from the foreign business for the specified taxation

year and each subsequent taxation year or fiscal period in which the foreign business is carried on by the operator

- the operator is deemed to carry on the foreign business in Canada throughout that part of the specified taxation year, and of each of those subsequent taxation years or fiscal periods, in which the foreign business is carried on by the operator, and

- for the purposes of Part XIV of the Regulations,

  - the operator is deemed to be required by law to report to, and to have been subject to the supervision of, the regulatory authority referred to in subparagraph 95(2)(*j*.1)(v), and

  - if the operator is a life insurer and the foreign business is a life insurance business, the life insurance policies issued in the conduct of that business are deemed to be life insurance policies in Canada.

For information about the new definition "taxable Canadian business", see the commentary to subsection 95(1).

In connection with the application of these new paragraphs, note the rule in new paragraph 95(2)(*k*.7). For detail, see the commentary for paragraph 95(2)(*k*.7).

These new paragraphs apply to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002. These amendments are included in the Fresh Start Section 95 Election package described at the beginning of the commentary to section 95.

Absent a Fresh Start Section 95 Election by a taxpayer resident in Canada in respect of the taxpayer's foreign affiliate, subsection 1402(2) of the Regulations (which was repealed by P.C. 1999-1154, SOR/99-269, dated June 23, 1999) ensures, if the foreign affiliate of the taxpayer resident in Canada itself is the operator, that a result similar to the result afforded the foreign affiliate by new paragraphs 95(2)(*j*.1) and (*j*.2) is afforded the foreign affiliate for the 1995 and prior taxation years of the foreign affiliate of the taxpayer resident in Canada.

ITA
95(2)(*k*) and (*k*.1)

Paragraph 95(2)(*k*) of the Act provides fresh start rules that, in general terms, are triggered if there is one of two types of changes to the business activities of a foreign affiliate of a taxpayer resident in Canada, namely:

- in a particular taxation year, the foreign affiliate of the taxpayer resident in Canada carries on an investment business outside Canada and, in the preceding taxation year, that business was not an investment business (as defined in subsection 95(1) of the Act) of the foreign affiliate, or

- in a particular taxation year, the foreign affiliate of the taxpayer resident in Canada is deemed by paragraph 95(2)(*a*.1), (*a*.2), (*a*.3) or (*a*.4) to carry on a separate business, other than an active business, and, in the preceding taxation year, the foreign affiliate was not deemed by that paragraph to be carrying on that separate business.

Paragraph 95(2)(*k*) refers to that investment business or that separate business as the "foreign business".

The fresh start rules, set out in paragraph 95(2)(*k*), also apply where a foreign affiliate of a taxpayer resident in Canada begins to carry on a particular business in the particular year and the particular business was an investment business of the foreign affiliate (or was comprised of activities deemed by paragraph 95(2)(*a*.1), (*a*.2), (*a*.3) or (*a*.4) to be a separate business, other than an active business, carried on by the foreign affiliate).

These fresh start rules apply for the purpose of computing the foreign accrual property income (FAPI), of a foreign affiliate of a taxpayer resident in Canada in respect of the taxpayer, from a foreign business for a particular taxation year of the foreign affiliate and for each subsequent taxation year in which the foreign business is considered to be carried on. In general terms, the fresh start rules provide for the following in computing the foreign affiliate's FAPI in respect of the taxpayer from the foreign business for those years:

- The foreign affiliate is deemed to have begun to carry on the foreign business in Canada at the later of the time the particular taxation year began and the time the foreign affiliate began carrying on the foreign business. The foreign affiliate is also deemed to have carried on the foreign business in Canada throughout that part of the particular taxation year and each subsequent taxation year in which the foreign business is considered to be carried on by the foreign affiliate.

- Where the foreign business is a business in respect of which the foreign affiliate would, if the foreign business were carried on in Canada, be required by law to report to a regulating authority such as the federal Superintendent of Financial Institutions or a similar

authority of a province, the foreign affiliate is deemed to have been subject to the supervision of such a regulating authority.

- Paragraphs 138(11.91)(*c*) to (*f*) of the Act apply to the foreign affiliate in respect of the foreign business as if the foreign affiliate were the insurer referred to in subsection 138(11.91), the particular taxation year were the particular year referred to in those paragraphs and the foreign business were the business of the insurer referred to in those paragraphs.

The fresh start rules in subparagraph 95(2)(*k*) ensure that the income of the foreign affiliate from the foreign business is calculated using Canadian tax rules. For example, the rule deeming the foreign affiliate to be subject to the supervision of a regulating authority permits the foreign affiliate to claim certain reserves in respect of insurance policies in connection with the foreign business. As well, there is a deemed disposition and reacquisition of property used or held in the foreign business immediately before the beginning of the particular taxation year. The fresh start rules ensure that income or losses accruing in prior periods do not enter into the income calculations for the foreign business in the particular taxation year or in subsequent taxation years.

A number of amendments are made to these fresh start rules. Note that paragraph 95(2)(*k*) is being divided into amended paragraph 95(2)(*k*) and new paragraph 95(2)(*k*.1). Amended paragraph 95(2)(*k*) defines the circumstances to which the fresh start rules apply, and new paragraph 95(2)(*k*.1) contains the substantive provisions of the fresh start rules.

Amended paragraph 95(2)(*k*) provides that new paragraph 95(2)(*k*.1) applies in respect of a particular taxation year of a foreign affiliate of a taxpayer resident in Canada and in respect of a particular fiscal period of a partnership at the end of which a foreign affiliate of a taxpayer resident in Canada is a member of the partnership (which foreign affiliate or partnership is referred to as the "operator" and which particular taxation year or particular fiscal period is referred to as the "specified taxation year") if the following four conditions are met:

- in the specified taxation year, the operator carries on a business (referred to in amended paragraph 95(2)(*k*) and, subject to new paragraph 95(2)(*k*.6), in new paragraph 95(2)(*k*.1), as a "foreign business"),

- the foreign business is not, at any time in the specified taxation year, a "taxable Canadian business",

- in the specified taxation year, the foreign business is
  - an investment business (clause 95(2)(*k*)(iii)(A)),
  - a business the activities of which include activities deemed by any of paragraphs 95(2)(*a*.1) to (*b*) to be a separate business, other than an active business, carried on by the foreign affiliate (clause 95(2)(*k*)(iii)(B)), or
  - a business the income from which is included by paragraph 95(2)(*l*) in computing the foreign affiliate's income from property for the specified taxation year (clause 95(2)(*k*)(iii)(C)),

and

- in the taxation year of the foreign affiliate, or fiscal period of the partnership, that includes the day that is immediately before the beginning of the specified taxation year)
  - the foreign affiliate or the partnership carried on the foreign business,
  - the foreign business was not, at any time, a "taxable Canadian business", and
  - the foreign business was not described in any of clauses 95(2)(*k*)(iii)(A), (B) and (C).

In connection with the first of these conditions, see the commentary to new subparagraph 95(2)(*k*.6).

New paragraph 95(2)(*k*.1) provides that, in computing the operator's income or loss from the foreign business, and in computing the operator's capital gain or capital loss from the disposition of property used or held in the course of carrying on the foreign business, for the specified taxation year and each subsequent taxation year or fiscal period in which the foreign business is carried on by the operator,

- the operator is deemed
  - to have begun to carry on the foreign business in Canada at the beginning of the specified taxation year, and
  - to carry on the foreign business in Canada throughout that part of the specified taxation year, and of each of those subsequent taxation years or fiscal periods, in which the foreign business is carried on by the operator,

(subparagraph 95(2)(*k*.1)(i))

- where, in respect of the foreign business, the operator would, if it were a corporation carrying on the foreign business in Canada, be required by law to report to, and be subject to the supervision of, a regulatory authority that is the Superintendent of Financial Institutions or a similar authority of a province,

  - the operator is deemed to have been required by law to report to, and to have been subject to the supervision of, such regulating authority, and

  - if the operator is a life insurer and the foreign business is a life insurance business, the life insurance policies issued in the conduct of that business are deemed to be life insurance policies in Canada,

  (subparagraph 95(2)(*k*.1)(ii))

- paragraphs 138(11.91)(*c*) to (*e*) of the Act apply to the operator for the specified taxation year in respect of the foreign business as if

  - the operator were the insurer referred to in subsection 138(11.91),

  - the specified taxation year of the operator were the particular taxation year of the insurer referred to in that subsection,

  - the foreign business of the operator were the business of the insurer referred to in that subsection, and

  - the reference in paragraph 138(11.91)(*e*) to "property owned by it at that time is designated insurance property in respect of the business" were read as a reference to "property owned or held by it at that time used or held by it in the particular taxation year in the course of carrying on the insurance business", (subparagraph 95(2)(*k*.1)(iii))

and

- if a particular property is deemed, because of the application of subparagraph 95(2)(*k*.1)(iii) and paragraph 138(11.91)(*e*), to have been disposed of in the preceding taxation year by the operator (which disposition is referred to in this subparagraph as a "particular disposition" of the particular property),

  - the amount of the foreign affiliate's income, gain or loss (which income, gain or loss is referred to in this subparagraph as the

"deferred amount") derived from the operator's income, gain or loss from the particular disposition of the particular property

- is to be included in computing the foreign affiliate's income, gain or loss for its taxation year that includes the last day of the operator's taxation year or fiscal period in which the particular property is disposed of by the operator in a disposition that is not the particular disposition, and

- is not to be included in computing the foreign affiliate's income, gain or loss for its taxation year that includes the last day of the operator's taxation year that includes the time of the particular disposition of the particular property, and

- the portion of the income taxes paid by the foreign affiliate to, or recovered by the foreign affiliate from, the government of a country other than Canada that may reasonably be considered to relate to the deferred amount is not to be included in determining income taxes paid to or recovered in respect of any other income, gain or loss of the foreign affiliate.

(subparagraph 95(2)(*k*.1)(iv))

In general terms, the amendments to paragraphs 95(2)(*k*) and (*k*.1) can be summarized as follows:

First, the amendments ensure that the fresh start rules apply not only if the particular business is carried on by a foreign affiliate of a taxpayer resident in Canada, but also if the particular business is carried on by a partnership of which a foreign affiliate of a taxpayer resident in Canada is a member. These amendments ensure, in the case of partnerships, that the fresh start rules will work on the basis of fiscal periods of the partnership and will therefore be relevant in the computation of the foreign affiliate 's foreign accrual property income for the foreign affiliate's taxation year that includes a fiscal period to which the fresh start rules apply. In amended paragraph 95(2)(*k*) and new paragraph 95(2)(*k*.1), the expression "operator" refers to the foreign affiliate (if the foreign affiliate directly carries on the particular business) or to the partnership (if the foreign affiliate carries on the particular business through the partnership).

Second, the amendments ensure that the fresh start rules are no longer triggered if the operator begins to carry on the particular business in the specified taxation year and did not carry on the particular business in the preceding taxation year. However, it is possible that, in such a situation, new paragraphs 95(2)(*j*.1) and (*j*.2) may apply. For further detail, see the commentary to new paragraphs 95(2)(*j*.1) and (*j*.2).

Third, the amendments ensure that the type of change in business activities that triggers the fresh start rules is a change that meets the following conditions:

- in the specified taxation year, the operator carries on a business (a "foreign business"),

- in the specified taxation year, the foreign business is

  - an investment business,

  - a business whose activities include activities deemed by any of paragraphs 95(2)(*a*.1) to (*b*) to be a separate business (other than an active business) carried on by the foreign affiliate, or

  - a business the income from which is included by paragraph 95(2)(*l*) in computing the foreign affiliate's income from property for the specified taxation year,

- in the preceding taxation year or fiscal period, the foreign affiliate or the partnership carried on the foreign business, and

- in that preceding taxation year or fiscal period, the foreign business was not described in any of clauses 95(2)(*k*)(iii)(A), (B) and (C).

Fourth, new paragraph 95(2)(*k*) provides that, in order for the fresh start rules to be triggered, the foreign business of the operator

- cannot, at any time in the specified taxation year, be a taxable Canadian business of the operator, and

- cannot, at any time in the preceding taxation year or fiscal period, have been a taxable Canadian business of the foreign affiliate or the partnership.

For more detail, see the commentary to the new definition "taxable Canadian business" in subsection 95(1) of the Act.

Fifth, new paragraph 95(2)(*k*.1) provides that life insurance policies issued by a foreign business of a foreign affiliate of a taxpayer resident in Canada in the conduct of that business are deemed to be life insurance policies in Canada if

- the operator would be required by law to report to the Superintendent of Financial Institutions or to a similar authority of a province in respect of the foreign business if the operator were a corporation carrying on the foreign business,

- the foreign business is a life insurance business, and
- the operator is a life insurer.

This new rule ensures that the operator is eligible to claim certain policy reserves in connection with the life insurance business.

Sixth, new paragraph 95(2)(*k*.1) makes it clear that, in applying paragraph 138(11.91)(*e*) of the Act to the fresh start rules, the reference in paragraph 138(11.91)(*e*) to "property owned by it at that time that is designated insurance property in respect of the business" is to be read as a reference to "property owned or held by it at that time that is used or held by the insurer in the particular taxation year in the course of carrying on the insurance business".

Seventh, consequential to the repeal of paragraph 138(11.91)(*f*) of the Act, the reference, in the fresh start rules, to "paragraphs 138(11.91)(*c*) to (*f*)" is changed to read "paragraphs 138(11.91)(*c*) to (*e*)". For more detail, see the commentary to subsection 138(11.91).

Eighth, subparagraph 95(2)(*k*.1)(iv) provides that the income, gain or loss from the deemed disposition of a particular property under subparagraph 95(2)(*k*.1)(iii) is only to be included in computing the foreign affiliate's income, gain or loss in the taxation year in which the property is disposed of in a transaction other than the deemed disposition. The recognition of foreign income tax recoveries paid or recovered that is related to the deferred income, gain or loss is to matched with the recognition of that income, gain or loss.

New paragraphs 95(2)(*k*) and (*k*.1) apply to taxation years of foreign affiliates of a taxpayer resident in Canada that begin after December 20, 2002. These amendments are included in the Fresh Start Section 95 Election package described at the beginning of the commentary to section 95.

However, note that this set of proposals sets out a number of transitional rules with respect to the application of paragraphs 95(2)(*k*) and (*k*.1).

First, in applying new paragraph 95(2)(*k*.1) for taxation years, of a foreign affiliate of the taxpayer, that begin on or before Announcement Date, that paragraph is to be read without reference to subparagraph 95(2)(*k*.1)(iv).

Second, in the case where the taxpayer has made a valid Fresh Start Section 95 Election, in applying new clause 95(2)(*k*)(iv)(C) of the Act, for taxation years, of all foreign affiliates of the taxpayer, that

begin before December 21, 2002, that clause is to be read in respect of those affiliates as follows:

*"(C) either*

*(I) the foreign business was not described in any of clauses (iii)(A) to (C), or*

*(II) the definition "investment business" in subsection (1) did not apply in respect of the foreign business in the specified taxation year;"*

Third, in applying existing subparagraph 95(2)(*k*)(iv) of the Act to taxation years, of foreign affiliates of a taxpayer, that end after 1999 and begin before December 21, 2002, that subparagraph is, unless the taxpayer makes a valid Fresh Start Section 95 Election, to be read as follows:

*"(iv) if the foreign business of the affiliate is a business in respect of which the affiliate would, if the foreign business were carried on in Canada, be required by law to report to a regulating authority in Canada such as the Superintendent of Financial Institutions or a similar authority of a province,*

*(A) the affiliate is deemed to be required by law to report to and to be subject to the supervision of such regulating authority, and*

*(B) if the affiliate is a life insurer and the foreign business of the affiliate is a life insurance business, the life insurance policies issued in the conduct of that business are deemed to be life insurance policies in Canada, and"*

***Example***

*Facts*

*Forco, a wholly-owned foreign affiliate of Canco, is deemed to carry on an investment business. The principal purpose of Forco's business is to derive income from trading or dealing in securities. The particular taxation year of Forco in respect of which paragraphs 95(2)(k) and (k.1) apply to the investment business is its taxation year ended December 31, 1995 (its "1995 taxation year"). Forco had acquired only one security for $10 million. The fair market value of the security was $12 million at the end of its taxation year that ended on December 31, 1994 (its "1994 taxation year"). Assume, for the purposes of this example, that Canco has made a valid Fresh Start Section 95 Election.*

*Application of paragraphs 95(2)(k) and (k.1)*

*Forco is deemed to have, at the end of its 1994 taxation year, disposed of all the securities used or held by it in respect of the investment business. The amount of $2 million (i.e., $12 million minus $10 million) would be added to the "earnings" of Forco in the taxation year in which it disposed of the securities. Following the deemed reacquisition of the securities at the beginning of its 1995 taxation year, Forco would have $12 million as the cost of its securities for the purposes of computing its income from the investment business. For additional detail, refer to the commentary to subsection 5907(2.9) of the Regulations.*

ITA
95(2)(*k*.2) and (*k*.3)

New paragraphs 95(2)(*k*.2) and (*k*.3) of the Act operate together and, in general terms, provide for fresh start rules that are triggered if a business carried on that is not an active business of a foreign affiliate of a taxpayer resident in Canada (or a business of a partnership of which the foreign affiliate is a member) becomes, in a particular taxation year of the foreign affiliate or in a particular fiscal period of the partnership (as the case may be), an active business. These fresh start rules apply in computing the foreign affiliate's foreign accrual property income (FAPI) in respect of the taxpayer from that business for the preceding taxation year or fiscal period.

Paragraph 95(2)(*k*.2) provides that paragraph 95(2)(*k*.3) applies in respect of a particular taxation year of a foreign affiliate of a taxpayer or in respect of a particular fiscal period of a partnership at the end of which a foreign affiliate of a taxpayer is a member of the partnership (which foreign affiliate or partnership is referred to as the "operator" and which particular taxation year or particular fiscal period is referred to as the "specified taxation year") if the following four conditions are met:

- in the preceding taxation year of the foreign affiliate or fiscal period of the partnership (which taxation year or fiscal period is referred to in this paragraph and paragraph (*k*.3) as the "preceding taxation year") that includes the day immediately before the beginning of the specified taxation year, the foreign affiliate or the partnership carried on a business (which is referred to in paragraph 95(2)(*k*.2) and, subject to paragraph (*k*.6), in paragraph 95(2)(*k*.3), as the "foreign business"),

- the foreign business was not, at any time in the preceding taxation year, a "taxable Canadian business",

- in the preceding taxation year, the foreign business was
  - an investment business (clause 95(2)(*k*.2)(iii)(A)),
  - a business whose activities included activities deemed by any of paragraphs 95(2)(*a*.1) to (*b*) to be a separate business, other than an active business, carried on by the affiliate (clause 95(2)(*k*.2)(iii)(B)), or
  - a business the income from which is included by paragraph 95(2)(*l*) in computing the affiliate's income from property for that preceding taxation year or fiscal period (clause 95(2)(*k*.2)(iii)(C)), and
- either
  - at any time in the specified taxation year the operator carries on the foreign business, and
    - the foreign business is an active business that is not a "taxable Canadian business" (subclause 95(2)(*k*.2)(iv)(A)(I), or
    - all or substantially all of the fair market value of the property of the operator used or held by the operator in the course of carrying on the foreign business is attributable to property of the operator that is excluded property (subclause 95(2)(*k*.2)(iv)(A)(II)), or
  - at no time in the specified taxation year does the operator carry on the foreign business.

In connection with the first of these four conditions, see the commentary on new subparagraph 95(2)(*k*.6).

For detail on the new definition "taxable Canadian business", see the commentary to subsection 95(1) of the Act.

The fresh start rules in paragraph 95(2)(*k*.3) provide that, in computing the operator's income or loss from the foreign business and in computing the operator's capital gain or capital loss from the disposition of property used or held in the course of carrying on the foreign business, for the preceding taxation year or fiscal period referred to in paragraph 95(2)(*k*.2) and for the specified taxation year of the operator and the operator's subsequent taxation years or fiscal periods,

- the operator is deemed to have ceased to carry on the foreign business in Canada at the beginning of the specified taxation year, and

- subject to subparagraph 95(2)(*k*.3)(iii), paragraphs 138(11.91)(*c*) to (*e*) of the Act apply to the operator for the specified taxation year in respect of the foreign business as if

  - the operator were the "insurer" referred to in subsection 138(11.91),

  - the specified taxation year of the operator were the "particular taxation year" of the insurer referred to in that subsection,

  - the foreign business of the operator were the business of the insurer referred to in that subsection,

  - the reference in paragraph 138(11.91)(*e*) to "property owned by it at that time that is designated insurance property in respect of the business" were read as a reference to "property owned or held by it at that time that is used or held by the insurer in the particular taxation year in the course of carrying on the insurance business", and

  - where, under subparagraph 95(2)(*k*.3)(iii), the taxpayer elects in prescribed manner and within the prescribed time (see proposed new section 5918 of the Regulations), to have that subparagraph apply in respect of every property that is deemed, because of the application of subparagraph 95(2)(*k*.3)(ii) and paragraph 138(11.91)(*e*), to have been disposed of in the specified taxation year by the operator (each such property referred to as the "particular property" and each such disposition referred to as the "particular disposition" of the particular property"), the following rules apply:

    - the amount of the foreign affiliate's income, gain or loss (which income, gain or loss is referred to as the "deferred amount") derived from the operator's income, gain or loss from a particular disposition of a particular property

      - is to be included in computing the foreign affiliate's foreign accrual property income in respect of the taxpayer for the foreign affiliate's taxation year that includes the last of the operator's taxation year or fiscal period in which the particular property is disposed of by the operator in a disposition that is not the particular disposition, and

- is not to be included in computing the foreign affiliate's foreign accrual property income in respect of the taxpayer for the foreign affiliate's taxation year that includes the last day of the operator's taxation year or fiscal period that includes the time of the particular disposition of the particular property, and

- the portion, of the income taxes paid by the foreign affiliate to, or recovered by the foreign affiliate from, the government of a country other than Canada that may reasonably be considered to relate to the deferred amount is not to be included in determining income taxes paid to or recovered in respect of any other income, gain or loss of the foreign affiliate.

Paragraphs 95(2)(*k*.2) and (*k*.3) ensure that, if a foreign business that is an active business in the specified taxation year was not an active business in the immediately preceding taxation year or fiscal period, as the case may be, any accrued gains will be included in computing the FAPI of the foreign affiliate in that preceding taxation year or fiscal period. The active business income of the foreign affiliate will reflect income, gains and losses accruing in the specified taxation year and in subsequent taxation years or fiscal periods, as the case may be. The reference, in subsection 95(2)(*k*.3), to paragraphs 138(11.91)(*c*) to (*e*), ensures that, immediately before the beginning of the specified taxation year, there is a deemed disposition and deemed reacquisition of property used or held in the foreign business.

New paragraphs 95(2)(*k.2*) and (*k*.3) apply to taxation years of a foreign affiliate of a taxpayer that begin after December 20, 2002. However, this set of proposals provides that, in applying new paragraph 95(2)(*k*.2) for taxation years, of a foreign affiliate of the taxpayer, that begin on or before Announcement Date, that paragraph is to be read without reference to subclause 95(2)(*k*.2)(iv)(A)(II).

***Example***

Facts

*Forco, a wholly-owned foreign affiliate of Canco, carried on a particular business that was an investment business throughout its taxation year that ended December 31, 2004. Forco is resident in a country that is a designated treaty country for the purposes of Part LIX of the Regulations. In its taxation year that ended December 31, 2005 (its "2005 taxation year"), business activities constitute an active business.*

*At the end of its 2004 taxation year, Forco owned capital property with a cost amount of $6 million, and inventory with a cost amount of $2 million, that was property used or held in the course of carrying on this business. At the end of that taxation year, the fair market value of Forco's capital property was $10 million and the fair market value of its inventory was $4 million.*

*Application of paragraphs 95(2)(k.2) and (k.3)*

*Forco would be deemed to have, immediately before the end of its 2004 taxation year, disposed of all of its property for proceeds equal to fair market value of that property at that time.*

*In connection with the deemed disposition of the capital property, Forco would be deemed to have a capital gain of $4 million (i.e., $10 million minus $6 million). Therefore, the taxable capital gain would be $2 million. Subject to a taxpayer election described below, the $2 million of taxable capital gains will be included in computing Forco's FAPI for the 2004 taxation year. Following the deemed reacquisition of the capital property at the end of its 2004 taxation year, Forco would have a cost in the amount of $10 million for the capital property.*

*Subject to a taxpayer election described below, in connection with the deemed disposition of the inventory, Forco would be deemed to have income of $2 million that would be included in computing the foreign accrual property income of Forco for its 2004 taxation year. Following the deemed reacquisition of the inventory at the end of its 2004 taxation year, Forco would have a cost in the amount of $4 million for the inventory.*

*For fresh starts in taxation years of a foreign affiliate of a taxpayer resident in Canada commencing after December 20, 2002, where the taxpayer elects (subparagraph 95(2)(k.3)(iv)), the gain and income arising because of the application of paragraph 95(2)(k.3) can be recognized by the foreign affiliate in the year the property is disposed of by foreign affiliate in a disposition other a disposition deemed, because of the application of subparagraph 95(2)(k.3)(ii) and paragraph 138(11.91)(e), to have occurred.*

ITA
95(2)(*k*.4)

The fresh start rules provided for in new paragraphs 95(2)(*k*) and (*k*.1) and in new paragraphs 95(2)(*k*.2) and (*k*.3), respectively, of the Act do not apply to a business the income from which is subject to tax under Part I of the Act. New paragraph 95(2)(*k*.4) provides for a

rule to deal with the situation where income from part of the business is subject to tax under Part I of the Act.

New paragraph 95(2)(*k*.4) provides that, if at any time a foreign affiliate of a taxpayer resident in Canada, or a partnership at the end of the fiscal period of which includes that time a foreign affiliate of a taxpayer resident in Canada is a member of the partnership, (which foreign affiliate or partnership is referred to as the "operator"), carries on a business both outside Canada and in Canada and income from that particular part of that business that is carried on in Canada is income from a taxable Canadian business, the following rules apply for the purposes of paragraphs 95(2)(*k*) to (*k*.3):

- the particular part of the business is deemed to be, at that time, a separate business,

- the assets used, or held, at that time primarily in the course of carrying on the particular part of the business are deemed to be, at that time, used or held in the course of carrying on the separate business,

- any liability incurred, and any reserve established, at that time in the course of carrying on the particular part of the business are deemed to be, at that time, incurred or established in the course of carrying on the separate business, and

- the transactions conducted at that time in the particular part of the business are deemed to be transactions conducted, at that time, in the separate business.

New paragraph 95(2)(*k*.4) applies to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002. This new paragraph is included in the Fresh Start Section 95 Election package described at the beginning of the commentary to section 95.

ITA
95(2)(*k*.5) and (*k*.6)

New paragraph 95(2)(*k*.6) of the Act, in combination with new paragraph 95(2)(*k*.5), provides application rules for the purposes of new paragraphs 95(2)(*k*.1) and (*k*.3).

New paragraph 95(2)(*k*.5) provides that new paragraph 95(2)(*k*.6) applies for the purpose of paragraphs 95(2)(*k*.1) and (*k*.3) in respect of a particular business of an operator if

- the particular business is the operator's foreign business for that specified or preceding taxation year, and

- the activities of the particular business for that specified or preceding taxation year include particular activities deemed by any of paragraphs 95(2)(*a*.1) to (*b*) to be a separate business, other than an active business, carried on by the foreign affiliate and the particular activities were not all the activities of the particular business in that specified or preceding taxation year.

New subparagraph 95(2)(*k*.6) provides that, in applying paragraphs 95(2)(*k*.1) and (*k*.3),

- the part of the particular business that consists of activities deemed by any of paragraphs 95(2)(*a*.1) to (*b*) to be a separate business, other than an active business, carried on by the foreign affiliate for a taxation year or fiscal period referred to in paragraph 95(2)(*k*.1) or (*k*.3), of the operator, is deemed to be the operator's foreign business carried on in that taxation year or fiscal period (subparagraph 95(2)(*k*.6)(i)),

- the assets used or held by the operator primarily in the course of carrying on activities deemed by any of paragraphs 95(2)(*a*.1) to (*b*) to be a separate business, other than an active business, carried on by the foreign affiliate for a taxation year or fiscal period, referred to in paragraph 95(2)(*k*) or (*k*.2), of the operator, are deemed to be assets used or held by the operator in the course of carrying on the foreign business in that taxation year or fiscal period (subparagraph 95(2)(*k*.6)(ii)),

- the portion of the liabilities incurred and the portion of the reserves established, in the course of carrying on activities deemed by any of paragraphs 95(2)(*a*.1) to (*b*) to be a separate business, other than an active business, carried on by the foreign affiliate for a taxation year or fiscal period, referred to in paragraph 95(2)(*k*) or (*k*.2), of the operator, are deemed to be liabilities incurred and reserves established in the course of carrying on the foreign business in that taxation year or fiscal period (subparagraph 95(2)(*k*.6)(iii)), and

- subject to subparagraphs 95(2)(*k*.6)(ii) and (iii), the transactions conducted in the course of carrying on activities deemed by any of paragraphs (*a*.1) to (*b*) to be a separate business, other than an active business, carried on by the foreign affiliate for a taxation year or fiscal period, referred to in paragraph 95(2)(*k*) or (*k*.2), of the operator, are, to the extent that those transactions relate to those activities, deemed to be transactions conducted in the course of carrying on the foreign business in that taxation year or fiscal period (subparagraph 95(2)(*k*.6)(iv)).

New paragraphs 95(2)(*k*.5) and (*k*.6) apply to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002.

These new paragraphs are included in the Fresh Start Section 95 Election package described at the beginning of the commentary to section 95.

ITA
95(2)(*k*.7)

New paragraph 95(2)(*k*.7) of the Act contains rules for the purposes of applying paragraphs 95(2)(*a*.1) to (*b*), (*j*.1) and (*j*.2), (*k*) to (*k*.6) and (*l*) and the definition "taxable Canadian business" in subsection 95(1).

This new paragraph provides that, if a person is (or is deemed by that paragraph to be) a member of a partnership and that partnership is a member of another partnership,

(i) in applying paragraphs 95(2)(*a*.1) to (*b*), (*j*.1) and (*j*.2), (*k*) to (*k*.6) and (*l*) and the definition "taxable Canadian business" in subsection 95(1), the person is deemed to be a member of the other partnership, and

(ii) in applying the definition "taxable Canadian business" in subsection 95(1), the person's share of the income or loss of the other partnership is deemed to be equal to the portion of that income or loss to which the person is directly or indirectly entitled.

Note that these deeming rules do not deem the actual or previously-deemed member not to be a member, nor do they deem such a member not to have the share of the income or loss.

New paragraph 95(2)(*k*.7) applies to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002. This new paragraph is included in the Fresh Start Section 95 Election package described at the beginning of the commentary to section 95.

ITA
95(2)(*l*)

Paragraph 95(2)(*l*) of the Act includes in the income, of a foreign affiliate of a taxpayer, from property the affiliate's income derived from a business the principal purpose of which is to derive income from trading or dealing in certain indebtedness. Where the business of the affiliate is described in subparagraph 95(2)(*l*)(iii) and the taxpayer is described in subparagraph 95(2)(*l*)(iv), paragraph 95(2)(*l*) does not apply to the affiliate.

Subparagraph 95(2)(*l*)(iii) refers to a business that is carried on by the affiliate as a foreign bank, a trust company, a credit union, an

insurance corporation or a trader or dealer in securities or commodities, the activities of which are regulated in the country under whose laws the affiliate was formed or continued and exists and is governed and in which the business is principally carried on.

Subparagraph 95(2)(*l*)(iii) is amended to refer to a business that is carried on by the affiliate as a foreign bank, a trust company, a credit union, an insurance corporation or a trader or dealer in securities or commodities, the activities of which are regulated under the laws

- of each country in which the business is carried on through a permanent establishment (as defined by proposed new section 8202 of the Regulations) in that country and of the country under whose laws the affiliate is governed and any of exists, was (unless the affiliate was continued in any jurisdiction) formed or organized, or was last continued,
- of the country in which the business is principally carried on, or
- if the affiliate is related to a non-resident corporation, of the country under whose laws that non-resident corporation is governed and any of exists, was (unless that non-resident corporation was continued in any jurisdiction) formed or organized, or was last continued, if those regulating laws are recognized under the laws of the country in which the business is principally carried on and all of those countries are members of the European Union.

Amended subparagraph 95(2)(*l*)(iii) applies to taxation years, of a foreign affiliate of a taxpayer, that begin after 1999.

ITA
95(2)(*n*)

Paragraph 95(2)(*a*) of the Act includes, in computing the income from an active business for a taxation year of a foreign affiliate of a taxpayer resident in Canada in respect of which the taxpayer has a "qualifying interest" throughout the year, certain amounts (described in the various subparagraphs of paragraph 95(2)(*a*)) that would otherwise be the foreign affiliate's income from property.

For example, subparagraph 95(2)(*a*)(ii) deals with the situation where the foreign affiliate derives income from certain amounts paid or payable to it by another foreign affiliate of the taxpayer in respect of which the taxpayer has a qualifying interest throughout the year (or from a partnership of which that other foreign affiliate is a member at the end of the year).

Paragraph 95(2)(*m*) determines whether a taxpayer has a "qualifying interest" in respect of a non-resident corporation that is a foreign affiliate of the taxpayer. This paragraph will not apply if the non-resident corporation is not a foreign affiliate of the taxpayer.

New paragraph 95(2)(*n*) accommodates a wider variety of corporate structures where the taxpayer has an indirect interest in a non-resident corporation.

New paragraph 95(2)(*n*) provides that, in applying paragraphs 95(2)(*a*) and (*g*) and subsections 95(2.2) and (2.21) and in applying paragraph (*d*) of the definition "exempt earnings", and paragraph (*c*) of the definition "exempt loss", in subsection 5907(1) of the Regulations, a non-resident corporation is deemed to be, at any time, a foreign affiliate of a particular corporation resident in Canada, and a foreign affiliate of the particular corporation resident in Canada in respect of which the particular corporation resident in Canada has a qualifying interest, if at that time

- the non-resident corporation is a foreign affiliate of another corporation that is resident in Canada and that is related (otherwise than because of a right referred to in paragraph 251(5)(*b*) of the Act) to the particular corporation, and

- that other corporation has a qualifying interest in respect of the non-resident corporation.

New paragraph 95(2)(*n*) applies to taxation years, of a foreign affiliate of a taxpayer, that end after 1999. Where the taxpayer elects in writing and files the election with the Minister of National Revenue on or before the taxpayer's filing-due date for the taxpayer's taxation year that includes the day on which these amendments are assented to, this new paragraph applies to the taxation years, of all foreign affiliates of the taxpayer, that begin after 1994.

***Example***

*Facts:*

1. *Canco1 is a corporation resident in Canada.*

2. *FA1 is a non-resident corporation. Canco1 owns all of the issued and outstanding shares in FA1.*

3. *Canco2 is a corporation resident in Canada. Canco1 owns all of the issued and outstanding shares in Canco2.*

*4. FA2 is a non-resident corporation. Canco2 owns all of the issued and outstanding shares of FA2.*

*Application of paragraph 95(2)(n):*

*In the absence of paragraph 95(2)(n), FA1 would not be a "foreign affiliate of Canco2 in respect of which Canco2 has a qualifying interest" because FA1 is not a foreign affiliate of Canco2 within the meaning of the definition "foreign affiliate" in subsection 95(1). Paragraph 95(2)(m) is of no assistance in this regard. Thus, income derived by FA2 from amounts paid or payable to it by FA1 could not satisfy subparagraph 95(2)(a)(ii) in respect of Canco2.*

*Under paragraph 95(2)(n), and only for the limited purposes outlined in paragraph 95(2)(n), FA1 is deemed to be a foreign affiliate of Canco2 and is deemed to be a foreign affiliate of Canco2 in respect of which Canco2 has a qualifying interest because*

- *Canco1 and Canco2 are related,*
- *FA1 is a foreign affiliate of Canco1, and*
- *Canco1 has, because of paragraph 95(2)(m), a qualifying interest in respect of FA1.*

ITA
95(2)(*o*)

New paragraph 95(2)(*o*) of the Act defines the expression "qualifying member" of a partnership. This new definition is relevant for the amended definition "investment business" in subsection 95(1) and for amended subparagraph 95(2)(*a*)(ii). For more detail, see the commentaries to subsection 95(1) and paragraph 95(2)(*a*).

The definition "qualifying member" in paragraph 95(2)(*o*) is also the basis for the new definition "qualifying member" in subsection 248(1). That definition is relevant for the purpose of the new definition "exempt earnings" in new subsection 5907(1) of the Regulations. For more detail, see the commentary to subsection 248(1) of the Act and subsection 5907(1) of the Regulations.

New paragraph 95(2)(*o*) provides that a particular person is a "qualifying member" of a partnership at a particular time if, at the particular time, the particular person is a member of the partnership and

- throughout the period, in the fiscal period of the partnership that includes the particular time, during which the member is a member of the partnership, the particular person is, on a regular, continuous and substantial basis

  - actively engaged in those activities, of the principal business of the partnership carried on in that fiscal period by the partnership, that are other than activities connected with the provision of or the acquisition of funds required for the operation of that principal business (clause 95(2)(*o*)(i)(A)), or

  - actively engaged in those activities, of a particular business carried on in that fiscal period by the particular person (otherwise than as a member of a partnership) that is similar to the principal business carried on in that fiscal period by the partnership, that are other than activities connected with the provision of or the acquisition of funds required for the operation of the particular business (clause 95(2)(*o*)(i)(B)), or

- throughout the period, in the fiscal period of the partnership that includes the particular time, during which the member was a member of the partnership

  - the total of the fair market value of all partnership interests in the partnership owned by the particular person was equal to or greater than 1% of the total of the fair market value of all partnership interests in the partnership owned by all members of the partnership (clause 95(2)(*o*)(ii)(A)), and

  - the total of the fair market value of all partnership interests in the partnership owned by the particular person or by persons (other than trusts) related to the particular person was equal to or greater than 10% of the total of the fair market value of all partnership interests in the partnership owned by all members of the partnership (clause 95(2)(*o*)(ii)(B)).

New paragraph 95(2)(*q*) provides look-through rules that apply where partnership interests in a partnership are owned by another partnership or by a "non-discretionary trust" (within the meaning assigned by subsection 17(15) of the Act). See the commentary to paragraph 95(2)(*q*) for more detail.

New paragraph 95(2)(*o*) applies to taxation years that end after 1999. New paragraph 95(2)(*o*) is included in the Global Section 95 Election package described at the beginning of the commentary to section 95.

ITA
95(2)(*p*)

New paragraph 95(2)(*p*) of the Act provides a definition for the expression "qualifying shareholder" of a corporation. This new expression is relevant for the amended definition "investment business" in subsection 95(1) of the Act. For more detail, see the commentary for the amendments to that definition.

New paragraph 95(2)(*p*) provides that a particular person is a "qualifying shareholder" of a corporation at any time if throughout the period, in the taxation year of the corporation that includes that time, during which the particular person is a shareholder of the corporation,

- the particular person owns 1% or more of the issued and outstanding shares (having full voting rights under all circumstances) in the corporation,

- the particular person, or the particular person and persons (other than trusts) related to the particular person, own 10% or more of the issued and outstanding shares (having full voting rights under all circumstances) in the corporation,

- the total of the fair market value of all the issued and outstanding shares of the corporation owned by the particular person is 1% or more of the total fair market value of all the issued and outstanding shares in the corporation, and

- the total of the fair market value of all the issued and outstanding shares of the corporation owned by the particular person or by persons (other than trusts) related to the particular person is 10% or more of the total fair market value of all the issued and outstanding shares in the corporation.

New paragraph 95(2)(*q*) provides look-through rules that apply if shares in the corporation are owned by a partnership or by a "non-discretionary trust" (within the meaning assigned by subsection 17(15) of the Act). See the commentary to paragraph 95(2)(*q*) for more detail.

New paragraph 95(2)(*p*) applies to taxation years, of a foreign affiliate of a taxpayer, that end after 1999. New paragraph 95(2)(*p*) is included in the Global Section 95 Election package described at the beginning of the commentary to section 95.

ITA
95(2)(*q*)

New paragraph 95(2)(*q*) of the Act provides look-through rules for the purposes of

- applying new paragraph 95(2)(*o*) if partnership interests in the partnership referred to in paragraph 95(2)(*o*) are owned by another partnership or by a "non-discretionary trust" (within the meaning assigned by subsection 17(15) of the Act), and

- applying new paragraph 95(2)(*p*) if shares in the corporation referred to in paragraph 95(2)(*p*) are owned by a partnership or by such a "non-discretionary trust".

New paragraph 95(2)(*q*) provides that, in applying paragraphs 95(2)(*o*) and (*p*),

- if interests in a partnership or shares of a corporation (such interests or shares referred to as "equity interests") are, at any time, property of a partnership or are deemed by paragraph 95(2)(*q*) to be, at any time, property of the partnership, the equity interests are deemed to be owned at that time by each member of the partnership in a proportion equal to the proportion of the equity interests that

    - the fair market value at that time of the member's partnership interest in the partnership

  is of

    - the fair market value at that time of all partnership interests in the partnership; and

- if interests in a partnership or shares of a corporation (which interests or shares are referred to as "equity interests") are, at any time, property of a non-discretionary trust (within the meaning assigned by subsection 17(15)) or are deemed under paragraph 95(2)(*q*) to be, at any time, property of a non-discretionary trust, the equity interests are deemed to be owned at that time by each beneficiary under that trust in a proportion equal to that proportion of the equity interests that

    - the fair market value at that time of the beneficiary's beneficial interest in the trust

  is of

- the fair market value at that time of all beneficial interests in the trust.

New paragraph 95(2)(*q*) applies to taxation years that end after 1999. New paragraph 95(2)(*q*) is included in the Global Section 95 Election package described at the beginning of the commentary to section 95.

ITA
95(2)(*r*)

New paragraph 95(2)(*r*) of the Act provides that, in applying paragraph 95(2)(*a*), a partnership is deemed to be, at any time, a partnership of which a foreign affiliate - of a particular corporation resident in Canada and in respect of which foreign affiliate the particular corporation has a qualifying interest - is a qualifying member if, at that time,

- a particular foreign affiliate, of another corporation that is resident in Canada and that is related (otherwise than because of a right referred to in paragraph 251(5)(*b*)) to the particular corporation, is a member of the partnership,

- that other corporation resident in Canada has a qualifying interest in respect of the particular foreign affiliate, and

- the particular foreign affiliate is a qualifying member of the particular partnership.

New paragraph 95(2)(*r*) applies to taxation years, of a foreign affiliate of a taxpayer, that end after 1999. Note that new paragraph 95(2)(*r*) is part of the Global Section 95 Election package described at the beginning of the commentary to section 95.

***Example***

<u>*Facts*</u>

*1. Canco owns all the shares of Cansub.*

*2. Cansub owns all the shares of FA1.*

*3. FA1 is a "qualifying member" (as defined in paragraph 95(2)(o)) of the partnership "P".*

*4. Canco owns all the shares of FA2.*

<u>*Application of Paragraph 95(2)(r)*</u>

*Partnership P is deemed to be a partnership of which FA2 (the particular foreign affiliate) is a qualifying member because:*

- *Canco (the particular corporation) has a qualifying interest in FA2 (condition in "preamble" to 95(2)(r)),*
- *FA1 (the particular foreign affiliate) is a member of P (condition in subparagraph 95(2)(r)(i));*
- *FA1 is a foreign affiliate of Cansub, which is a corporation resident in Canada that is related to Canco (condition in subparagraph 95(2)(r)(i)),*
- *Cansub has a qualifying interest in FA1 (condition in subparagraph 95(2)(r)(ii)), and*
- *FA1 is a qualifying member of P (condition in subparagraph 95(2)(r)(iii)).*

ITA
95(2)(*s*)

New paragraph 95(2)(*s*) of the Act provides that, in applying the definition "investment business" in subsection 95(1), a particular corporation is, at any time, a designated corporation in respect of a foreign affiliate of a taxpayer if, at that time,

- a qualifying shareholder of the foreign affiliate or a person related to such a qualifying shareholder is a qualifying shareholder of the particular corporation,
- the particular corporation
  - is controlled by a qualifying shareholder of the foreign affiliate, or
  - would be controlled by a particular qualifying shareholder of the foreign affiliate if the particular qualifying shareholder of the foreign affiliate owned each share of the capital stock of the particular corporation that is owned by a qualifying shareholder of the foreign affiliate or by a person related to a qualifying shareholder of the foreign affiliate, and
- the total of all amounts each of which is the fair market value of a share of the capital stock of the particular corporation owned by a qualifying shareholder of the foreign affiliate or by a person related

to a qualifying shareholder of the foreign affiliate is greater than 50% of the total fair market value of all the issued and outstanding shares of the capital stock of the particular corporation.

New paragraph 95(2)(*s*) applies to taxation years, of a foreign affiliate of a taxpayer, that end after 1999. Note that this new paragraph is included in the Global Section 95 Election package described in the beginning of the commentary to section 95.

***Example***

*Facts*

1. *Corporation 1 controls Corporations 2 and 3.*
2. *Corporation 2 is a qualifying shareholder of FA1.*
3. *Corporation 1 owns shares that represent more than 50% of the fair market value of all issued shares of Corporations 2 and 3.*
4. *Corporation 1 is a qualifying shareholder of Corporation 3.*

*Application of Paragraph 95(2)(s)*

*Corporation 3 (the particular corporation) is a designated corporation in respect of FA1 because*

- *Corporation 1 is related to Corporation 2 and is a qualifying shareholder of Corporation 3, and*

- *Corporation 3 would be controlled by Corporation 2 if Corporation 2 owned each share of Corporation 3 that is owned by Corporation 1, and*

- *Corporation 1 owns shares that represent more than 50% of the fair market value of all issued shares of Corporation 3.*

ITA
95(2)(*t*)

New paragraph 95(2)(*t*) of the Act provides that, in applying the definition "investment business" in subsection 95(1), a particular partnership is, at any time, a designated partnership in respect of a foreign affiliate of a taxpayer if, at that time,

- the foreign affiliate or a person related to the foreign affiliate is a qualifying member of the particular partnership, and

- the total of all amounts each of which is the fair market value of a partnership interest in the particular partnership held by the foreign affiliate, by a person related to the foreign affiliate or by a

qualifying member of the operating partnership (described in the investment business definition) is greater than 50% of the total fair market value of all partnership interests in the particular partnership owned by all members of the particular partnership.

New paragraph 95(2)(*t*) applies to taxation years, of a foreign affiliate of a taxpayer, that end after 1999. Note that this new paragraph is included in the Global Section 95 Election package described in the beginning of the commentary to section 95.

ITA
95(2)(*u*)

New paragraph 95(2)(*u*) of the Act provides that, in applying the definition "controlled foreign affiliate" in subsection 95(1), shares of the capital stock of a corporation, that are at any time owned by, or that are deemed by subsection 95(2) to be at any time owned by, another corporation, are deemed to be, at that time, owned by, or property of, as the case may be, each shareholder of the other corporation in the proportion that

- the fair market value at that time of the shares of the capital stock of the other corporation that, at that time, are owned by, or are property of, the shareholder

is of

- the fair market value at that time of all the issued and outstanding shares of the capital stock of the other corporation.

Note that this deeming rule does not deem the actual or previously-deemed owner not to own the shares.

See the commentary to the definition "controlled foreign affiliate" for details about amendments to that definition.

New paragraph 95(2)(*u*) applies to taxation years, of a foreign affiliate of a taxpayer, that begin after Announcement Date.

ITA
95(2)(*v*)

New paragraph 95(2)(*v*) of the Act provides that, in applying the definition "controlled foreign affiliate" in subsection 95(1), shares of the capital stock of a corporation that are, or are deemed by subsection 95(2) to be, at any time, property of a partnership, are deemed to be, at that time, owned by, or property of, as the case may be, each member of the partnership in the proportion that

- the fair market value at that time of the member's partnership interest in the partnership

is of

- the fair market value at that time of all partnership interests in the partnership.

Note that this deeming rule does not deem the actual or previously-deemed owner not to own the shares.

See the commentary to the definition "controlled foreign affiliate" for details about amendments to that definition.

New paragraph 95(2)(*v*) applies to taxation years, of a foreign affiliate of a taxpayer, that begin after Announcement Date.

ITA
95(2)(*w*)

New paragraph 95(2)(*w*) of the Act provides that, in applying the definition "controlled foreign affiliate" in subsection 95(1), shares of the capital stock of a corporation, that are at any time owned by, or that are deemed by subsection 95(2) to be at any time owned by, a non-discretionary trust (within the meaning assigned by subsection 17(15)) other than an exempt trust (within the meaning assigned by subsection 95(3.2)) are deemed to be, at that time, owned by, or property of, as the case may be, each beneficiary of the trust in the proportion that

- the fair market value at that time of the beneficiary's beneficial interest in the trust

is of

- the fair market value at that time of all beneficial interests in the trust.

Note that this deeming rule does not deem the actual or previously-deemed owner not to own the shares.

See the commentary to the definition "controlled foreign affiliate" for details about amendments to that definition.

New paragraph 95(2)(*w*) applies to taxation years, of a foreign affiliate of a taxpayer, that begin after Announcement Date.

ITA
95(2)(*x*)

New paragraph 95(2)(*x*) of the Act provides that, in applying the definition "controlled foreign affiliate" in subsection 95(1), all of the shares of the capital stock of a corporation, that are owned at any time by, or deemed by subsection 95(2) to be owned at any time by, a particular trust (other than an exempt trust within the meaning assigned by subsection 95(3.2) or a non-discretionary trust within the meaning assigned by subsection 17(15)), are deemed to be, at that time, owned by, or property of, as the case may be,

(i) each beneficiary of the particular trust at that time, and

(ii) each settlor (within the meaning assigned by subsection 17(15)) in respect of the particular trust at that time.

Note that this deeming rule does not deem the actual or previously-deemed owner not to own the shares.

See the commentary to the definition "controlled foreign affiliate" for details about amendments to that definition.

New paragraph 95(2)(*x*) applies to taxation years, of a foreign affiliate of a taxpayer, that begin after Announcement Date.

ITA
95(2)(*y*)

New paragraph 95(2)(*y*) of the Act provides that, in new paragraphs 95(2)(*c*.3), (*f*.5) and (*h*.2) and new clauses 95(2)(*k*.1)(iv)(B) and (*k*.3)(iii)(B), the expression "government of a country" includes the government of a province, state or other political subdivision of that country.

New paragraph 95(2)(*y*) applies after December 20, 2002.

**Rule for Definition "investment business"**

ITA
95(2.1)

Subsection 95(2.1) of the Act provides a rule for the purpose of the arm's length test in paragraph (*a*) of the definition "investment business" in subsection 95(1). Under this rule, a foreign affiliate of a taxpayer, the taxpayer and, in certain circumstances, a regulated financial institution in Canada of which the taxpayer is a subsidiary wholly-owned corporation, are considered to be dealing with each

other at arm's length in respect of the entering into (and the execution of) agreements that provide for the purchase or sale, or exchange, of currency where all four of the conditions specified in paragraphs 95(2.1)(*a*) to (*d*) are satisfied.

The first condition, as specified in paragraph 95(2.1)(*a*), is that the taxpayer be (or be a corporation all of the issued shares of which are owned by a corporation that is) a bank, a trust company, a credit union, an insurance corporation or a trader or dealer in securities, the business activities of which are by law subject to the supervision of the Superintendent of Financial Institutions or a similar provincial authority.

The second condition, as specified in paragraph 95(2.1)(*b*), is that the agreements be swap agreements, forward purchase or sale agreements, forward rate agreements, futures agreements, options or rights agreements or similar agreements.

The third condition, as specified in paragraph 95(2.1)(*c*), is that the foreign affiliate entered into the agreements in the course of a business carried on principally with arm's length persons in the country in which the affiliate was formed (or continued) and exists and is governed, and in which the business is principally carried on by it.

The fourth condition, as specified in paragraph 95(2.1)(*d*), is that the terms and conditions of the sale or exchange be arm's length terms and conditions.

Subsection 95(2.1) permits a foreign affiliate of a taxpayer to deal with Canadian financial institutions in currency transactions entered into in the course of a business carried on by the affiliate principally with arm's length persons in the foreign country under whose laws the affiliate was incorporated, exists and is governed, and in which the business is principally carried on. Such currency transactions of the affiliate are afforded the same tax treatment as that given to similar transactions conducted with foreign financial institutions.

Paragraph 95(2.1)(*c*) is amended to require that the foreign affiliate entered into the agreements

- in the course of carrying on, principally with persons with whom the affiliate deals at arm's length, a business (other than a life insurance business) principally carried on in the country (other than Canada) under whose laws the affiliate is governed and any of exists, was (unless the affiliate was continued in any jurisdiction) formed or organized, or was last continued, or

- in the course of a life insurance business carried on by the affiliate principally in a country other than Canada and principally with persons with whom the affiliate deals at arm's length if

    - that country is the country in which the business is principally carried on or is the country under whose laws the affiliate is governed and any of exists, was (unless the affiliate was continued in any jurisdiction) formed or organized, or was last continued (new clause 95(2.1)(*c*)(ii)(A)), and

    - the business activities of the affiliate are regulated in each of the countries described in new clause 95(2.1)(*c*)(ii)(A).

Amended subsection 95(2.1) will, for example, accommodate currency transactions of certain regulated foreign affiliates, of regulated life insurance corporations resident in Canada, that carry on an arm's length foreign life insurance business principally in a country different from their country of incorporation or continuation if the business activities are regulated in the country in which the business is principally carried on and in the country under whose laws the affiliate was incorporated or last continued.

The amendment to paragraph 95(2.1)(*c*) applies to taxation years, of a foreign affiliate of a taxpayer, that begin after 1999. However, see the commentary to new subsection 95(2.2) for details of an election to apply the amendments to amendment to paragraph 95(2.1)(*c*) to taxation years, of all foreign affiliates of the taxpayer, that begin after 1994. Note also that the amendment to paragraph 95(2.1)(*c*) is included in the Global Section 95 Election package described at the beginning of the commentary to section 95.

**Rule for Subsection 95(2)**

ITA
95(2.2)

Subsection 95(2.2) of the Act provides rules, in paragraphs 95(2.2)(*a*) and (*b*), for the purpose of subsection 95(2).

Paragraph 95(2.2)(*a*) provides that, in certain circumstances, a non-resident corporation that was not a "foreign affiliate of a taxpayer in respect of which the taxpayer had a qualifying interest throughout a taxation year" but was such a foreign affiliate at the beginning or end of that year is deemed to be such a foreign affiliate of the taxpayer throughout that year. Those circumstances are that a person has, in that year, acquired or disposed of shares of that non-resident corporation or any other corporation and, because of that disposition or acquisition, that non-resident corporation became or ceased to be a

foreign affiliate of the taxpayer in respect of which the taxpayer had a qualifying interest.

Paragraph 95(2.2)(*b*) provides that, in certain circumstances, a non-resident corporation that was not related to a taxpayer and to a foreign affiliate of the taxpayer throughout a taxation year but was so related at the beginning or end of that year is deemed to be related throughout that year to the taxpayer and to the foreign affiliate. Those circumstances are that a person has, in that year, acquired or disposed of shares of that non-resident corporation or any other corporation and, because of that disposition or acquisition, that non-resident corporation became or ceased to be a non-resident corporation that was related to the foreign affiliate and the taxpayer.

Subsection 95(2.2) is amended in the following ways.

First, the "preamble" of subsection 95(2.2) is amended to ensure that that subsection does not apply for the purpose of paragraph 95(2)(*f*). This amendment is consequential to the introduction of new subsection 95(2.22). For additional detail, see the commentary to subsection 95(2.22).

Second, paragraph 95(2.2)(*b*) is amended so that the rule in that paragraph also applies if, because of the acquisition, that non-resident corporation would have become (if paragraph 251(5)(*b*) of the Act did not apply to rights contained in the agreement under which the person acquired the shares) a non-resident corporation that was related to the taxpayer or to the taxpayer and the foreign affiliate. The addition of the reference to paragraph 251(5)(*b*) permits paragraph 95(2.2)(*b*) to apply where the relevant commercial arrangements involve a right to acquire shares which is then exercised.

The amendments to paragraph 95(2.2)(*b*) and to the "preamble" of subsection 95(2.2) apply to taxation years, of a foreign affiliate of a taxpayer, that end after 1999. However, if a taxpayer so elects in writing and files the election with the Minister of National Revenue on or before the taxpayer's filing-due date for the taxpayer's taxation year that includes the day on which this set of amendments is assented to, the following apply to taxation years, of all foreign affiliates of the taxpayer, that begin after 1994:

- the amendments to the portion of paragraph 95(2)(*f*) after subparagraph (ii) and before subparagraph (iii),
- the amendments to paragraph 95(2.1)(*c*),
- the amendments to the "preamble" to subsection 95(2.2),

- the amendments to paragraph 95(2.2)(*b*), and

- new subsection 95(2.21).

This set of proposals provides that, notwithstanding subsections 152(4) to (5) of the Act, the Minister of National Revenue can make any assessment of a taxpayer's tax, interest and penalties payable under the Act for any taxation year that is necessary to take such an election into account.

Note also that the amendment to the "preamble" of subsection 95(2.2) is included in the Global Section 95 Election package described at the beginning of the commentary to section 95.

**Exception re Subsection 95(2.2)**

ITA
95(2.21)

New subsection 95(2.21) of the Act ensures that the application of the rules in subsection 95(2.2) will not result in the provisions of paragraph 95(2)(*a*) recharacterizing, as an income or a loss from an active business, any income or loss from property of a particular foreign affiliate of the taxpayer in respect of which the taxpayer has a qualifying interest or is related throughout the taxation year of that particular affiliate, that relates to a transaction or event

- that occurred before that particular affiliate became, as determined without reference to subsection 95(2.2), a foreign affiliate of the taxpayer in respect of which the taxpayer had a qualifying interest or to which the taxpayer is related; or

- that occurred before a non-resident corporation (other than that particular affiliate), or a foreign affiliate of the taxpayer (other than that particular affiliate), referred to in paragraph 95(2)(*a*) became, as determined without reference to subsection 95(2.2),

  - a foreign affiliate of a taxpayer in respect of which the taxpayer had a qualifying interest, or

  - related to the taxpayer and to that particular affiliate.

New subsection 95(2.21) applies to taxation years, of a foreign affiliate of a taxpayer, that end after 1999. However, see the commentary to new subsection 95(2.2) for details of an election to apply new subsection 95(2.21) to taxation years, of all foreign affiliates of the taxpayer, that begin after 1994. Note also that new

subsection 95(2.21) is included in the Global Section 95 Election package described at the beginning of the commentary to section 95.

**Rule for Paragraph 95(2)(*a*.1)**

ITA
95(2.3)(*b*)

Subsection 95(2.3) of the Act exempts a foreign affiliate from the application of paragraph 95(2)(*a*.1) with respect to the sale or exchange of property that is currency when the conditions in that subsection are met.

One condition, found in paragraph 95(2.3)(*b*), is that the sale or exchange of property that is currency is made in course of a business carried on by the affiliate principally with arm's length persons in the country in which the affiliate is formed or organized and exists and is governed and in the country in which the business is principally carried on.

Paragraph 95(2.3)(*b*) is modified to require the sale or exchange to be made by the foreign affiliate in the course of a business conducted principally with arm's length persons. As well, the following conditions must be met:

- the business must be principally carried on in the country under whose laws the affiliate is governed and any of exists, was (unless the affiliate was continued in any jurisdiction) formed or organized, or was last continued, or

- if the affiliate is a foreign bank, a trust company, a credit union, an insurance corporation, or a trader or dealer in securities or commodities and the activities of the business are regulated

  - under the laws of the country under whose laws the affiliate is governed and any of exists, was (unless the affiliate was continued in any jurisdiction) formed or organized, or was last continued and under the laws of each country in which the business is carried on through a permanent establishment (as defined by proposed new Regulation 8202) in that country,

  - under the laws of the country in which the business is principally carried on, or

  - if the affiliate is related to a particular corporation, under the laws of the country under the laws of which the particular corporation is governed and any of exists, was (unless the particular corporation was continued in any jurisdiction) formed

or organized, or was last continued, if those regulating laws are recognized under the laws of the country in which the business is principally carried on and all of those countries are members of the European Union.

Amended paragraph 95(2.3)(*b*) applies to taxation years, of a foreign affiliate of a taxpayer, that begin after 1999.

**Exception re Paragraph 95(2)(*a*.3)**

ITA
95(2.4)

In general terms, paragraph 95(2)(*a*.3) of the Act deems income of a foreign affiliate of a taxpayer from Canadian source indebtedness, or from Canadian source lease obligations, to be income from a business other than an active business. Therefore, this income will be included in computing the affiliate's foreign accrual property income (FAPI).

Subsection 95(2.4) provides that paragraph 95(2)(*a*.3) will not apply in respect of income derived by a foreign affiliate of a taxpayer directly or indirectly from indebtedness to the extent that

- the income was derived by the affiliate in the course of a business that was conducted principally with persons with whom the affiliate deals at arm's length, and that was carried on by the affiliate as a foreign bank, a trust company, a credit union, an insurance corporation or a trader or dealer in securities or commodities, the activities of which are regulated in the jurisdiction in which it was formed or continued and exists and is governed, and in which the business was principally carried (paragraph 95(2.4)(*a*)), and

- the income was derived from the trading or dealing in such indebtedness with arm's length persons resident in a country other than Canada in which the affiliate and its similarly regulated competitors compete and have a substantial market presence (paragraph 95(2.4)(*b*)).

Paragraph 95(2.4)(*a*) is amended to refer to income derived by the affiliate in the course of a business that was conducted principally with persons with whom the affiliate deals at arm's length, and that was carried on by the affiliate as a foreign bank, a trust company, a credit union, an insurance corporation, or a trader or dealer in securities or commodities, the activities of which are regulated under the laws

- of the country under whose laws the affiliate is governed and any of exists, was (unless the affiliate was continued in any jurisdiction) formed or organized, or was last continued and of each country in which the business is carried on through a permanent establishment (as defined by proposed new Regulation 8202) in that country,

- of the country in which the business is principally carried on, or

- if the affiliate is related to a corporation, of the country under the laws of which that related corporation is governed and any of exists, was (unless that related corporation was continued in any jurisdiction) formed or organized, or was last continued, if those regulating laws are recognized under the laws of the country in which the business is principally carried on and all of those countries are members of the European Union.

Amended paragraph 95(2.4)(*a*) applies to taxation years, of a foreign affiliate of a taxpayer, that begin after1999.

**Exception re Paragraph 95(2)(*a*.3)**

ITA
95(2.41)

In general terms, paragraph 95(2)(*a*.3) of the Act deems income of a foreign affiliate of a taxpayer from Canadian source indebtedness, or from Canadian source lease obligations, to be income from a business other than an active business. This income will therefore be included in computing the affiliate's FAPI. In general terms, new subsection 95(2.41) of the Act provides that paragraph 95(2)(*a*.3) will not apply to income of a foreign affiliate of a taxpayer from Canadian source indebtedness held by that affiliate where that indebtedness is used or held

- to fund a liability or reserve of the foreign life insurance business of the affiliate, or

- as capital that can reasonably be considered to have been required for that life insurance business.

More specifically, new subsection 95(2.41) provides that, where four conditions are met, paragraph 95(2)(*a*.3) does not apply to a foreign affiliate of a taxpayer resident in Canada in respect of the affiliate's income for a taxation year derived, directly or indirectly, from indebtedness of persons resident in Canada or from indebtedness in respect of businesses carried on in Canada (referred to as the "Canadian indebtedness").

The first condition, set out in paragraph 95(2.41)(*a*), is that the taxpayer be at the end of the affiliate's taxation year

- a life insurance corporation resident in Canada, the business activities of which are subject by law to the supervision of the Superintendent of Financial Institutions or a similar authority of a province, or

- a corporation resident in Canada that is a subsidiary controlled corporation of such a life insurance corporation.

The second condition, set out in paragraph 95(2.41)(*b*), is that the Canadian indebtedness be used or held by the affiliate, throughout the period (in the taxation year) that it was used or held by the affiliate, in the course of carrying on a business (referred to as the "foreign life insurance business") that is a life insurance business carried on outside Canada (other than a business deemed by paragraph 95(2)(*a*.2) to be a "separate business other than an active business"), the activities of which are regulated

- in the country under whose laws the affiliate is governed and any of exists, was (unless the affiliate was continued in any jurisdiction) formed or organized, or was last continued, and

- in the country, if any, in which the business is principally carried on.

The third condition, set out in paragraph 95(2.41)(*c*), is that more than 90% of the gross premium revenue of the affiliate for the taxation year in respect of the foreign life insurance business be derived from the insurance or reinsurance of risks (net of reinsurance ceded) in respect of persons

- that were non-resident at the time that the policies in respect of those risks were issued or effected, and

- that were at that time dealing at arm's length with the affiliate, the taxpayer and all persons that were related at that time to the affiliate or the taxpayer.

The fourth condition, set out in paragraph 95(2.41)(*d*), is that it be reasonable to conclude that the affiliate used or held the Canadian indebtedness

- to fund a liability or reserve of the foreign life insurance business, or

- as capital that can reasonably be considered to have been required for the foreign life insurance business.

In general terms, new subsection 95(2.41) ensures that a life insurer can hold Canadian source indebtedness in its foreign life insurance business without causing the income from that indebtedness to be treated as FAPI of the foreign affiliate.

New subsection 95(2.41) applies to taxation years, of a foreign affiliate of a taxpayer, that begin after 1999. New subsection 95(2.41) is included in the Global Section 95 Election package described at the beginning of the commentary to section 95.

**Definition "indebtedness"**

ITA
95(2.5)

The definition "indebtedness" in subsection 95(2.5) of the Act provides an exception for a foreign affiliate of a certain Canadian taxpayers from the rules in subsection 95(2)(*a*.3) for indebtedness arising under agreements providing for the purchase, sale or exchange of currency if the conditions set out that definition are met.

One condition, found in paragraph (*c*) of the definition, is that agreements providing for the purchase, sale or exchange of currency must be entered into in the course of a business carried on by the foreign affiliate principally with arm's length persons in the country under whose laws the affiliate is formed or organized and exists and is governed and in the country in which the business is principally carried on.

Paragraph (*c*) is modified to require that the agreements providing for the purchase, sale or exchange of currency must be entered into in the course of a business conducted principally with arm's length persons. As well, the following conditions must be met:

- the business must be carried on principally in the country under whose laws the foreign affiliate is governed and any of exists, was (unless the affiliate was continued in any jurisdiction) formed or organized, or was last continued; or

- the foreign affiliate must be a foreign affiliate of a person described in paragraph 95(2.3)(*a*), and that person must be a foreign bank, a trust company, a credit union, an insurance corporation, or a trader or dealer in securities or commodities, and the activities of the business must be regulated

- under the laws of the country under whose laws the affiliate is governed and any of exists, was (unless the affiliate was continued in any jurisdiction) formed or organized, or was last continued and under the laws of each country in which the business is carried on through a permanent establishment (as defined by proposed new Regulation 8202) in that country,

- under the laws of the country in which the business is principally carried on, or

- under the laws of the country under whose laws a corporation related to the non-resident corporation is governed and any of exists, was (unless that related corporation was continued in any jurisdiction) formed or organized, or was last continued, if those regulating laws are recognized under the laws of the country in which the business is principally carried on and all of those countries are members of the European Union.

The amendments apply to taxation years, of a foreign affiliate of a taxpayer, that begin after 1999.

**Definition "services"**

ITA
95(3)(*c*) and (*d*)

Paragraph 95(2)(*b*) of the Act provides that service income of a controlled foreign affiliate of a taxpayer will, under certain circumstances, be treated as income from a business other than an active business.

Subsection 95(3) provides that, for the purpose of paragraph 95(2)(*b*), "services" includes the insurance of Canadian risks but does not include

- the transportation of persons or goods (paragraph 95(3)(*a*)), or

- services performed in connection with the purchase or sale of goods (paragraph 95(3)(*b*)).

New paragraph 95(3)(*c*) ensures that, for the purpose of paragraph 95(2)(*b*), the transmission of electronic signals or electricity along a transmission system located outside Canada does not constitute "services".

New paragraph 95(3)(*d*) accommodates certain types of contract manufacturing services provided by a foreign affiliate of a taxpayer. That paragraph ensures that, for the purpose of paragraph 95(2)(*b*),

manufacturing or processing does not constitute "services" where it consists of manufacturing or processing outside Canada, in accordance with the taxpayer's specifications and under a contract between the taxpayer and the affiliate, of tangible property that is owned by the taxpayer if the property resulting from the manufacturing or processing is used or held by the taxpayer in the ordinary course of the taxpayer's business carried on in Canada.

New paragraphs 95(3)(*c*) and (*d*) apply to the 2001 and subsequent taxation years of a foreign affiliate of a taxpayer. However, if the taxpayer elects in writing and files the election with the Minister of National Revenue on or before the taxpayer's filing-due date for the taxpayer's taxation year that includes the day on which these amendments are assented to, new paragraphs 95(3)(*c*) and (*d*) apply to the taxation years, of all foreign affiliates of the taxpayer, that begin after 1994. Note, also, that new paragraph 95(3)(*d*) is included in the Global Section 95 Election package described at the beginning of the commentary to section 95.

**"designated property" - Subparagraph 95(2)(*a*.1)(i)**

ITA
95(3.1)

New subsection 95(3.1) of the Act provides, for the purpose of amended subparagraph 95(2)(*a*.1)(i) of the Act, a definition of the expression "designated property". For more detail about that definition, see the commentary to subparagraph 95(2)(*a*.1)(i).

New subsection 95(3.1) applies after to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002. However, a taxpayer may elect to apply this amendment to taxation years that begin after 1994. For details about the election, refer to the commentary to subparagraph 95(2)(*a*.1)(i).

**Definitions**

ITA
95(3.2)

New subsection 95(3.2) of the Act provides definitions for the purposes of new subsections 95(3.2), (3.3) to (3.6) and new paragraphs 95(2)(*c*.1) to (*c*.6), (*e*.2) to (*e*.5), and (*f*.3) to (*f*.9).

See the commentary for those proposed new subsections and paragraphs for further detail.

Note also that the expression "exempt trust", as defined in subsection 95(3.2), is also used in new paragraphs 95(2)(*w*) and (*x*) by reference. For detail, see the commentary to those paragraphs.

**"dividend-like redemption"**

"Dividend-like redemption" of a share of a foreign affiliate (referred to here as the "issuing foreign affiliate") of a corporation resident in Canada is a redemption, an acquisition or a cancellation (referred to here as the "redemption") of the share if

- the share is excluded property (or would be excluded property if the holder of the share were a foreign affiliate of the corporation resident in Canada) of another foreign affiliate, of the corporation resident in Canada, that, immediately before the redemption, held the share, and

- the surplus entitlement percentage of the corporation resident in Canada, in respect of the issuing foreign affiliate, immediately before the redemption, is equal to the surplus entitlement percentage of the corporation resident in Canada, in respect of the issuing foreign affiliate, immediately after the redemption.

**"eligible trust"**

"Eligible trust", at any time, is a trust other than

- a trust created or maintained for charitable purposes,

- a trust governed by an employee benefit plan,

- a trust described in paragraph (*a*.1) of the definition "trust" in subsection 108(1),

- a trust governed by a salary deferral arrangement,

- a trust established for the purpose of administering a superannuation, pension, retirement, or employee benefits plan, or

- a trust that, at or before the time, was a personal trust.

**"exempt trust"**

"Exempt trust", at a particular time, in respect of a taxpayer resident in Canada, is a trust that, at that time, is a trust under which the interest of each beneficiary (in this definition determined without reference to subsection 248(25)) under the trust is, at all times that the interest exists during the trust's taxation year that includes the

particular time, a specified fixed interest of the beneficiary in the trust, if at the particular time

- the trust is an eligible trust,

- there are at least 150 beneficiaries each of whom holds a specified fixed interest in the trust with a fair market value of at least $500, and

- the total of all amounts each of which is the fair market value of an interest as a beneficiary under the trust held by a specified purchaser in respect of the taxpayer resident in Canada is not more than 10% of the total fair market value of all interests as a beneficiary under the trust.

**"participating interest"**

"Participating interest" in a corporation, trust or partnership, as the case may be, (referred to here as the "entity") is a property that is

- where the entity is a corporation, a share of the capital stock of that corporation,

- where the entity is a trust, an interest as a beneficiary under that trust,

- where the entity is a partnership, an interest in that partnership, and

- under a contract, in equity or otherwise, either immediately or in the future, and absolutely or contingently, convertible into, exchangeable for or a right to acquire, directly or indirectly, a property described in paragraphs (*a*) to (*c*) of this definition, or a property the fair market value of which is determined principally by reference to those properties.

The expression "entity" is defined in new amended subsection 95(1). See the commentary to subsection 95(1) for more detail.

**"specified fixed interest"**

"Specified fixed interest", at a particular time, in a trust is a capital interest in the trust if

- the interest includes, at the particular time, a right of the interest holder as a beneficiary under the trust to receive, at or after the particular time and directly from the trust, income or capital of the trust,

- the interest was acquired, at or before the particular time, from the trust by any interest holder for consideration equal to its fair market value at the time of that acquisition, and

- no right as a beneficiary under the trust to any income or capital of the trust may cease to be a right of the interest holder otherwise than because of a disposition of the interest for consideration equal to the fair market value of the interest at the time of disposition or because of the disposition of the interest as a gift.

**"specified purchaser"**

"Specified purchaser", at any time, in respect of a particular corporation resident in Canada is a person or partnership that is, at that time,

- the particular corporation,

- a taxpayer resident in Canada with which the particular corporation does not deal at arm's length,

- a foreign affiliate of a person described above,

- a non-resident taxpayer with which a person described above does not deal at arm's length,

- a trust (other than an exempt trust) in which any person or partnership described above or below has a beneficial interest, or

- a partnership in which a person or partnership described above has, directly or indirectly, in any manner whatever, a partnership interest.

**"specified vendor"**

"Specified vendor", at any time, in respect of a particular corporation resident in Canada, is a person or partnership that is, at that time,

- a foreign affiliate of the particular corporation,

- a foreign affiliate of a partnership of which the particular corporation is a member,

- a partnership a member of which is a person described above, or

- a partnership in which any person or partnership described above has, directly or indirectly, in any manner whatever, a partnership interest.

Subsection 95(3.2) applies after December 20, 2002.

**Definitions for paragraphs 95(2)(*c*.1) to (*c*.6)**

ITA
95(3.3)

New subsection 95(3.3) of the Act provides definitions for the purposes of subsection 95(3.3) and paragraphs (2)(*c*.1) to (*c*.6). See the commentary for those proposed new paragraphs for further detail.

**"contributed property"**

"Contributed property" is a property

- that was held by the disposed foreign affiliate at the original disposition time, and was held by a person or partnership that was not a specified purchaser in respect of the particular corporation resident in Canada immediately after a transaction or event, or series of transactions or events that includes,
  - a particular disposition described in clauses (*a*)(i)(A) and (ii)(B) of the definition "triggering disposition",
  - the dissolution, winding-up, or cessation of the existence, described in paragraph (*a*) of the definition "specified discontinuance", or
  - a merger or combination described in paragraph (*b*) of the definition "specified discontinuance", and
- for which it is reasonable to conclude that one of the main reasons for holding the property at the original disposition time was
  - to avoid the disqualification of the particular disposition as a triggering disposition, or
  - to avoid the characterization of a particular dissolution, winding-up, or cessation of the existence, of a specified purchaser in respect of a particular corporation resident in Canada as a specified discontinuance.

**"specified discontinuance"**

"Specified discontinuance" of a current holder in respect of a particular corporation resident in Canada is

- a dissolution, winding-up, or a cessation of the existence, of a corporation or partnership if, immediately after a transaction or event, or series of transactions or events that includes the dissolution, winding-up or cessation, a person or partnership that is a specified purchaser in respect of the particular corporation resident in Canada,

  - holds the specified share, or

  - holds property that, immediately after the commencement of the transaction or event or of the series, was property (or property substituted for such property) of the disposed foreign affiliate that, immediately before that commencement, had a total fair market value that was greater than 50% of the total fair market value, immediately before that commencement, of all of the property (other than contributed property) of the disposed foreign affiliate,

- a merger or combination of corporations or partnerships if, immediately after a transaction or event that is, or series of transactions or events that includes, the merger or combination, a person or partnership that is a specified purchaser in respect of the particular corporation resident in Canada,

- holds the specified share, or

- holds property that, immediately before the commencement of the transaction or event or of the series, was property (or property substituted for such property) of the disposed foreign affiliate that, immediately before that commencement, had a total fair market value that was greater than 50% of the total fair market value of all of the property (other than contributed property) of the disposed foreign affiliate, or

- a disposition of a participating interest in the current holder if, in the course of a transaction or event that is, or series of transactions or events that includes, the disposition of the participating interest, the specified share (or any portion of the specified share) or a right to or an interest in the specified share (or any portion of the interest in the specified share) becomes property of a person or partnership that is a specified purchaser in respect of the particular corporation resident in Canada.

Note that the expression "contributed property" is defined in new subsection 95(3.3).

**"triggering disposition"**

"Triggering disposition" of a specified share in respect of a particular corporation resident in Canada is the first disposition, after the original disposition time, of the specified share to a person or partnership that is, immediately after that first disposition, not a specified purchaser in respect of the particular corporation resident in Canada, but does not include

- a disposition of the specified share in respect of the particular corporation resident in Canada that arises in the course of

    - a dissolution, winding-up, or a cessation of the existence, of

        - the disposed foreign affiliate if, immediately after a transaction or event that is, or series of transactions or events that includes, the dissolution, winding-up or cessation, a specified purchaser in respect of the particular corporation resident in Canada holds property that, immediately before the commencement of the transaction or event or of the series, was property (or property substituted for such property) of the disposed foreign affiliate that, immediately before that commencement, had a total fair market value that was greater than 50% of the total fair market value, immediately before that commencement, of all the property (other than contributed property) of the disposed foreign affiliate, or

        - a current holder in respect of the particular corporation resident in Canada if, immediately after a transaction or event that is, or series of transactions or events that includes, the dissolution, winding-up or cessation, a specified purchaser in respect of the particular corporation resident in Canada holds the specified share (or any portion of the specified share) or a right to or an interest in the specified share (or any portion of the right to or interest in the specified share), or

    - a merger or combination of corporations or partnerships if, immediately after a transaction or event that is, or series of transactions or events that includes, the merger or combination, a specified purchaser in respect of the particular corporation resident in Canada holds

        - the specified share (or any portion of the specified share) or a right to or an interest in the specified share (or any portion of the right to or interest in the specified share), or

    - property that, immediately before the commencement of the transaction or event or of the series, was property (or property substituted for such property) of the disposed foreign affiliate that, immediately before that commencement, had a total fair market value that was greater than 50% of the total fair market value, immediately before that commencement, of all of the property (other than contributed property) of the disposed foreign affiliate;

- a disposition of the specified share in respect of the particular corporation resident in Canada that is part of a series of transactions or events that includes

  - the disposition of the specified share to a person or partnership that is not an a specified purchaser in respect of the particular corporation resident in Canada, and

  - the acquisition, by a specified purchaser in respect of the particular corporation resident in Canada, of

    - the specified share (or any portion of the specified share) or a right to or an interest in the specified share (or any portion of the right to or interest in the specified share),

    - a share, a right to a share, or a right to acquire a share (which share or right is referred to here as a "substituted share") of the same or a substantially similar class of shares of the disposed foreign affiliate as the specified share or a substituted share, or

    - a property the fair market value of which is determined primarily by reference to property that is the specified share (or a substituted share) or to property that, at the original disposition time, was property (or property substituted for it) of the disposed foreign affiliate, or to any combination of those properties; or

- a particular disposition of the specified share in respect of the particular corporation resident in Canada if, immediately after a transaction or event that is, or series of transactions or events that includes, the particular disposition,

  - a specified purchaser in respect of the particular corporation resident in Canada holds property (other than contributed property) the fair market value of which is derived primarily from property that was, immediately before the original disposition time,

- property of the disposed foreign affiliate,

- property from which property of the disposed foreign affiliate primarily derived its fair market value, or

- any combinations of such properties or properties substituted for such properties, and

- the fair market value of those properties is greater than 50% of the fair market value, immediately before the original disposition time, of all of the property the disposed foreign affiliate.

Subsection 95(3.3) applies after December 20, 2002.

**Definitions for paragraphs 95(2)(*f*.3) to (*f*.9)**

ITA
95(3.4)

New subsection 95(3.4) of the Act provides definitions for the purposes of proposed new paragraphs 95(2)(*f*.3) to (*f*.9). See the commentary for those proposed new paragraphs for further detail.

**"specified discontinuance"**

"Specified discontinuance" of a current holder described in paragraph 95(2)(*f*.5) is

- a dissolution, winding-up, or cessation of the existence, of a corporation or partnership if, immediately after a transaction or event that is, or series of transactions or events that includes, the dissolution, winding-up or cessation, a specified purchaser, in respect of the particular corporation, holds the specified property,

- a merger or combination of corporations or partnerships if, immediately after a transaction or event that is, or series of transactions or events that includes, the merger or combination, a specified purchaser, in respect of the particular corporation, holds the specified property, or

- a disposition of a participating interest in the current holder if, in the course of a transaction or event that is, or series of transactions or events that includes, the disposition of the participating interest, the specified property (or any portion of the specified property) or a right to or an interest in the specified property (or any portion of the specified property) becomes property of a specified purchaser in respect of the particular corporation.

**"triggering disposition"**

"Triggering disposition", of a specified property in respect of a particular corporation resident in Canada, is the first disposition, after the original disposition time, of the specified property to a person or partnership that is, immediately after that first disposition, not a specified purchaser in respect of the particular corporation, but does not include

- a disposition of the specified property in respect of the particular corporation resident in Canada that arises in the course of

  - a dissolution, winding-up, or cessation of the existence, of a corporation or partnership if, immediately after a transaction or event that is, or series of transactions or events that includes, the dissolution, winding-up or cessation, a specified purchaser in respect of the particular corporation holds the specified property, and

  - a merger or combination of corporations or partnerships if, immediately after a transaction or event that is, or series of transactions or events that includes, the merger or combination, a specified purchaser in respect of the particular corporation holds the specified property, or

- a disposition of the specified property in respect of the particular corporation resident in Canada that is part of a series of transactions or events that includes

- the disposition of the specified property to a person or partnership other than a specified purchaser in respect of the particular corporation resident in Canada, and

- the acquisition, by a specified purchaser in respect of the particular corporation, of

  - the specified property (or any portion of the specified property) or a right to or an interest in the specified property (or any portion of the right to or interest in the specified property) (which right, interest or portion is referred to for the purposes of paragraphs 95(2)(*f*.7) and (*f*.9) as a "designated replacement property"),

  - a property or a right to acquire a property (which property or right is referred to here and for the purposes of paragraphs 95(2)(*f*.7) and (*f*.9) as a "designated replacement property") that is substantially similar to the specified property or to the designated replacement property, or

- a property (referred to for the purposes of paragraphs 95(2)(*f*.7) and (*f*.9) as a "designated replacement property") the fair market value of which is determined primarily by reference to property that is the specified property or properties from which the specified property primarily derived its fair market value at the original disposition time.

Subsection 95(3.4) applies after December 20, 2002.

**Definitions for paragraphs 95(2)(*h*) to (*h*.5)**

ITA
95(3.5)

New subsection 95(3.5) of the Act provides definitions for the purposes of paragraphs 95(2)(*h*) to (*h*.5). See the commentary for those proposed new paragraphs for further detail.

**"specified discontinuance"**

"Specified discontinuance", of a current holder described in paragraph 95(2)(*h*.2), is

- a dissolution, winding-up, or cessation of the existence, of a corporation or partnership if, immediately after a transaction or event that is, or series of transactions or events that includes, the dissolution, winding-up or cessation, a specified purchaser in respect of the particular taxpayer holds the specified property,

- a merger or combination of corporations or partnerships if, immediately after a transaction or event that is, or series of transactions or events that includes, the merger or combination, a person or partnership that is a specified purchaser in respect of the particular taxpayer holds the specified property, or

- a disposition of a participating interest in the current holder if, in the course of a transaction or event that is, or series of transactions or events that includes, the disposition of the participating interest, the specified property (or any portion of the specified property) or a right to, or an interest in, the specified property (or any portion of the specified property) becomes property of a specified purchaser in respect of the particular taxpayer.

**"specified purchaser"**

"Specified purchaser", at any time, in respect of a particular taxpayer resident in Canada, is a person or partnership that is, at that time,

- the particular taxpayer,
- a taxpayer resident in Canada with which the particular taxpayer does not deal at arm's length,
- a foreign affiliate of a person described above,
- a non-resident taxpayer with which a person described above does not deal at arm's length,
- a trust (other than an exempt trust) in which a person or partnership described above or below is beneficially interested, or
- a partnership in which a person or partnership described above has, directly or indirectly in any manner whatever, a partnership interest.

**"specified vendor"**

"Specified vendor", at any time, in respect of a particular taxpayer resident in Canada, is a person or partnership that is, at that time,

- a foreign affiliate of the particular taxpayer,
- a foreign affiliate of a partnership of which the particular taxpayer is a member,
- a partnership a member of which is a person described above, or
- a partnership in which any person or partnership described above has, directly or indirectly in any manner whatever, a partnership interest.

**"triggering disposition"**

"Triggering disposition", of a specified property in respect of a particular taxpayer resident in Canada, is the first disposition, after the original disposition time, of the specified property, to a person or partnership that is, immediately after that first disposition, not a specified purchaser in respect of the particular taxpayer, but does not include

- a disposition of the specified property in respect of the particular taxpayer resident in Canada that occurs in the course of

  - a dissolution, winding-up, or cessation of the existence, of a corporation or partnership if, immediately after a transaction or event that is, or series of transactions or events that includes, the dissolution, winding-up or cessation, a specified purchaser in respect of the particular taxpayer holds the specified property, or

  - a merger or combination of corporations or partnerships if, immediately after a transaction or event that is, or series of transactions or events that includes, the merger or combination, a specified purchaser in respect of the particular taxpayer holds the specified property, and

- a disposition of the specified property in respect of the particular taxpayer resident in Canada that is part of a series of transactions or events that includes

  - the disposition of the specified property to a person or partnership other than a specified purchaser in respect of the particular taxpayer resident in Canada, and

  - the acquisition by, a specified purchaser in respect of the particular taxpayer resident in Canada, of

- the specified property (or any portion of the specified property) or a right to or an interest in the specified property (or any portion of the right to or interest in the specified property) (which right, interest or portion is referred to for the purposes of paragraphs 95(2)(*h*.3) and (*h*.5) as a "designated replacement property"),

- a property or a right to acquire a property (which property or right is referred to here and for the purposes of paragraphs 95(2)(*h*.3) and (*h*.5) as a "designated replacement property") that is substantially similar to the specified property or to the designated replacement property, or

- a property (which property is referred to for the purposes of paragraphs 95(2)(*h*.3) and (*h*.5) as a "designated replacement property") the fair market value of which is determined primarily by reference to property that is the specified property or properties from which the specified property primarily derived its fair market value at the original disposition time.

Subsection 95(3.5) applies after December 20, 2002.

**Partnerships and trusts**

ITA
95(3.6)

New subsection 95(3.6) of the Act provides rules to be used in determining if a non-resident corporation is a foreign affiliate of a particular corporation resident in Canada or of a particular taxpayer resident in Canada for the purposes of paragraphs 95(2)(*c*.1) to (*c*.5), (*e*.3) to (*e*.5), (*f*.3) to (*f*.9) and (*h*) to (*h*.5) and subsections 95(3.2) to (3.5) where a person or partnership is a member of a partnership or a beneficiary under a trust.

New subsection 95(3.6) provides that in determining if a non-resident corporation is a foreign affiliate of a particular corporation resident in Canada or of a particular taxpayer resident in Canada, as the case may be, in circumstances where, at any time, a person or partnership (which person or partnership is referred to here as the "holder") is a member of a partnership, or has a beneficial interest in a trust (other than an exempt trust),

- the partnership or trust, as the case may be, is deemed to be a non-resident corporation having capital stock of a single class divided into 100 issued shares,

- the holder is deemed to own at that time that proportion of the issued shares of that class that the fair market value of the holder's partnership interest in the partnership or of the holder's beneficial interest in the trust, as the case may be, is of the fair market value at that time of all partnership interests in the partnership or of all beneficial interests in the trust, as the case may be, and

- the fair market value, at any time, of the holder's beneficial interest in a trust (other than a non-discretionary trust within the meaning assigned by subsection 17(15)) is deemed to be the fair market value, at that time, of all beneficial interests in the trust.

Subsection 95(3.6) applies after December 20, 2002.

**Anti-avoidance - 150 beneficiaries**

ITA
95(3.7)

New subsection 95(3.7) of the Act provides that if it can be reasonably considered that one of the main reasons that an entity holds, at any time, a capital interest in a trust is to cause the trust to

satisfy the condition in paragraph (*b*) of the definition "exempt trust" in subsection 95(3.2), the trust is deemed not to have satisfied at that time that condition.

Subsection 95(3.7) applies after December 20, 2002.

**Computing Exempt Surplus**

ITA
95(3.8)

New subsection 95(3.8) of the Act is an anti-avoidance rule to prevent the premature recognition of exempt surplus (the non-taxable portion of a capital gain) on an internal sale of excluded property to which any of proposed new paragraphs 95(2)(*d*) and (*e*) and (*e*.3) to (*e*.5) applies. Although capital gains on internal sales of excluded property, to which those paragraphs apply, create foreign accrual property income, where the foreign affiliate is not a controlled foreign affiliate of the particular corporation resident in Canada the particular corporation resident in Canada is not subjected to Canadian tax on that foreign accrual property income. Therefore, the particular corporation resident in Canada can be advantaged on an internal disposition of excluded property by claiming a relevant cost base, or electing proceeds of disposition, greater than the adjusted cost base of the property disposed of, in particular where the foreign jurisdiction does not tax capital gains. Where the foreign jurisdiction does tax capital gains, the particular corporation resident in Canada may wish to recognize gains because of the foreign taxes paid and the desire to create taxable surplus to match the related taxes, which would be appropriate where the amount of tax reflects Canadian tax rates on capital gains.

New subsection 95(3.8) provides that no amount may be added to the exempt surplus of a foreign affiliate of a particular corporation resident in Canada in respect of the gain arising on the internal disposition of excluded property if it is reasonable to conclude that one of the main reasons for claiming a relevant cost base, or electing proceeds of disposition, greater than the adjusted cost base of the property disposed of on that internal disposition was the creation of exempt surplus in respect of the particular corporation resident in Canada or in respect of a corporation resident in Canada with which the particular corporation resident in Canada does not deal at arm's length.

The factors to consider in making this determination include the following:

- the amount of foreign income tax paid,

- the amount of distribution made, or dividend paid, to the particular corporation resident in Canada or to a corporation resident in Canada with which the particular corporation resident in Canada does not deal at arm's length, and

- the amount of any election under section 93 made in respect of a disposition of a share of a foreign affiliate of the particular corporation resident in Canada or of a share of a foreign affiliate of a corporation resident in Canada with which the particular corporation resident in Canada does not deal at arm's length.

Subsection 95(3.8) applies after December 20, 2002.

**Clause 134**

**Interpretation**

ITA
248

Section 248 of the Act defines a number of terms that apply for the purposes of the Act, and sets out various rules relating to the interpretation and application of various provisions of the Act.

**Definitions**

ITA
248(1)

**"qualifying member"**

The definition "qualifying member" is added to subsection 248(1) of the Act.

Under this definition a qualifying member, in respect of a partnership at any time, means a person that is at that time a qualifying member of the partnership for the purposes of subdivision i of Division B of Part I of the Act because of paragraph 95(2)(*o*) of the Act. For more detail, see the commentary to new paragraphs 95(2)(*o*) and (*q*).

This definition is also relevant for the purposes of the amendments to the definitions "exempt earnings" and "exempt loss" in subsection 5907(1) of the Regulations. For more detail, see the commentary to that subsection.

The addition of the definition "qualifying member" applies to taxation years that end after 1999.

# APPENDIX A

# PENSIONS AND QUALIFIED LIMTED PARTNRSHIPS

**Information Returns - RRSPs and RRIFs**

ITR
214(5)

Subsection 214(5) of the *Income Tax Regulations* requires issuers of registered retirement savings plans (RRSPs) to file information returns for transfers from RRSPs. It is intended that this reporting requirement apply only for transfers relating to a division of property arising on the breakdown of a marriage or common-law partnership. However, a recent amendment to subsection 214(5) inadvertently broadened the kinds of transfers to which it applies. Subsection 214(5) is amended to correct this result by replacing the reference in it to subsection 146(16) of the *Income Tax Act* with a reference to paragraph 146(16)(*b*), effective after 2002.

ITR
215(5)

Subsection 215(5) of the Regulations requires carriers of registered retirement income funds (RRIFs) to file information returns for transfers from RRIFs relating to a division of property arising on the breakdown of a marriage or common-law partnership. Subsection 215(5) is amended, effective after 2003, to replace the reference to paragraph 146.3(14)(*b*) of the Act with a reference to subsection 146.3(14). This amendment is strictly consequential to a restructuring of subsection 146.3(14) and does not represent a change to existing reporting requirements.

**Deferred Income Plans - Qualified Investments**

ITR
Part XLIX

Part XLIX of the Regulations lists a number of qualified investments for RRSPs, RRIFs, registered education savings plans (RESPs) and deferred profit sharing plans (DPSPs).

ITR
4900(1)(*e*)

Paragraph 4900(1)(*e*) of the Regulations provides that a warrant or right that gives the holder the right to acquire property is a qualified

investment, provided that the underlying property is a qualified investment.

This paragraph is amended in two ways. First, it is amended to add an arm's length test. To qualify, the issuer of the warrant or right will be required, on an on-going basis, to deal at arm's length with each person who is an annuitant, a beneficiary, an employer or a subscriber under the registered plan. Second, the underlying property will be required to be a share or unit of the issuer or a share or unit of another person or partnership that, at the time of issuance, does not deal at arm's length with the issuer.

This amendment applies in respect of property acquired after Announcement Date.

ITR
4900(1)(*e*.01)

New paragraph 4900(1)(*e*.01) of the Regulations provides that an option that is listed on a stock exchange referred to in section 3200 or 3201 of the Regulations is a qualified investment, provided that the underlying property is a qualified investment and regardless of whether settlement is made by way of delivery of the underlying property or by cash payment. The effect of this change is to enable RRSPs, RRIFs, RESPs and DPSPs to acquire publicly-listed put options and cash-settled index options, in addition to call options (which were already qualified investments under former paragraph 4900(1)(*e*)).

This amendment applies after Announcement Date.

ITR
4900(1)(*i*.3)

New paragraph 4900(1)(*i*.3) of the Regulations provides that a debt obligation issued by a Canadian corporation or a trust resident in Canada is a qualified investment, subject to the following requirements:

- the principal purpose of the issuer is to derive income from the holding of indebtedness;

- the debt obligation derives all or substantially all of its value from the indebtedness held by the issuer;

- at least 80% of the issuer's property is indebtedness owed by Canadian residents;

- the debt obligation had an investment grade rating with a recognized rating agency when it was acquired by the plan trust; and

- the debt obligation was issued as part of single debt issue of at least $25 million.

Paragraph 4900(1)(*i*.3) is intended, in particular, to accommodate investments in debt obligations (commonly known as asset-backed securities) that are backed by cash flows from pools of loans and other receivables. Paragraph 4900(1)(*i*.3) applies after Announcement Date.

ITR
4900(1)(*j*)

Paragraph 4900(1)(*j*) of the Regulations provides that a mortgage obligation that is secured on real property situated in Canada is a qualified investment. For this purpose, paragraph 4901(3)(*a*) provides that a reference to a mortgage includes a charge, hypothec or similar instrument pertaining to real property, as well as an interest in a mortgage.

Paragraph 4900(1)(*j*) is amended to ensure that a mortgage obligation qualifies only if the amount of the mortgage obligation (together with the amount of any other indebtedness in respect of the property that is of equal or superior rank) does not exceed the fair market value of the property, except as a result of a decline in the fair market value of the real property after issuance of the mortgage obligation. This test applies on an on-going basis. This amendment is consistent with the introduction of subparagraph (*g*)(iii) to the definition of "foreign property" in subsection 206(1) of the Act.

Amended paragraph 4900(1)(*j*) applies after Announcement Date, except that it does not apply before 2005 in respect of property acquired on or before Announcement Date. This is intended to give a plan trust that holds a bona fide mortgage obligation, which fails to satisfy the new test, until the end of 2004 to either dispose of the obligation or arrange for adequate real property security.

ITR
4900(1)(*n*.01)

New paragraph 4900(1)(*n*.01) of the Regulations provides that debt of a limited partnership whose units are listed on a Canadian stock exchange referred to in section 3200 of the Regulations is a qualified investment. This amendment applies after Announcement Date.

**Deferred Income Plans - Foreign Property**

ITR
Part L

Part XI of the Act imposes a penalty tax on excess foreign property held by certain trusts and other tax-exempt persons governed by deferred income plans. The expression "foreign property" is defined in subsection 206(1) of the Act to include an interest in a partnership, except as otherwise prescribed by regulation. Section 5000 of the Regulations sets out those exceptions.

**Qualified Limited Partnerships**

ITR
5000

Subsection 5000(1.3) of the Regulations, which deals with qualified limited partnerships (QLPs), states that the specified portion of a limited unit in a QLP that is held at any time by a specified partner of the QLP is non-foreign property. "Limited unit" and "qualified limited partnership" are defined in subsection 5000(7) of the Regulations, and "specified partner" has the meaning assigned by subsection 5000(1.5) of the Regulations.

Pursuant to subsection 5000(1.4) of the Regulations, the specified portion of a limited unit of a QLP held at any time by a specified partner is the whole of the unit if the specified partner does not hold more than 30% of the limited units of the partnership (either alone or with other partners with whom the specified partner is not dealing at arm's length). Otherwise, the specified portion of the unit corresponds to the proportion of property held by the QLP that is non-foreign property. In other words, when the 30% ownership limit is exceeded, the specified portion of a limited unit of a QLP is that portion of the unit that the total cost amount to the QLP, at that time, of all its non-foreign property is of the total cost amount to it, at that time, of all its property.

According to the definition in subsection 5000(7) of the Regulations, a QLP is a limited partnership that has met the following conditions, among others, at all times since its formation:

- The QLP's general partner's share in each income and loss of the partnership, for any particular period, is identical, regardless of the source of the income or the loss. An exception is possible for the general partner's share of the income or loss generated from specified property (within the meaning of subsection 5100(1) of the

Regulations), which may vary from the general partner's share from any other source (paragraph (*b*)).

- The general partner's share in income and losses of the partnership for any particular period is not less than the general partner's share for any previous period (paragraph (*c*)).

- The interests of the limited partners are described by reference to units in the partnership, which are identical in all regards (paragraph (*d*)).

- The partnership's investments are limited to those described in paragraph (*f*).

- The cost amount of foreign property held by the partnership does not exceed the allowed percentage (currently 30%) of the cost amount to it of all property held by it (paragraph (*i*)).

Non-compliance with any of these conditions, at any time, results in the permanent loss of QLP status and, consequently, the whole of the units held in the partnership are deemed to be foreign property pursuant to subsection 206(1) of the Act.

A number of amendments to the QLP definition and to the definition of the specified portion of a limited unit in a QLP will provide greater flexibility. In particular, holding more than 30% foreign property will no longer affect the designation of a partnership as a QLP. As a result, exceeding the 30% foreign property limit will no longer have the effect of deeming all of the partnership's units to be entirely foreign property on a permanent basis. However, when the foreign property limit is exceeded, limited units held by specified partners will qualify as non-foreign property only in proportion to the non-foreign property held by the QLP. Furthermore, at any time in the future that the QLP satisfies the foreign property limit, the whole of the limited units held by specified partners (except those exceeding the 30% ownership threshold) will qualify as non-foreign property.

The new consequences set out in the preceding paragraph are the result of the repeal of paragraph (*i*) of the QLP definition, which contains the condition limiting the foreign property that can be held by a QLP, and the addition of the foreign property rule to the definition of "specified portion" in subsection 5000(1.4).

In short, the modifications to the way in which a QLP is affected if the foreign property limit is exceeded result in less severe consequences by:

- allowing the non-foreign property portion of the units of the QLP to be determined on a proportional basis, rather than completely disqualifying the units from non-foreign property treatment; and

- allowing the whole of the units of the QLP to be treated as non-foreign property at any subsequent time that the QLP complies with the foreign property limit.

In addition to the modifications to the foreign property rule, the QLP definition is amended to accommodate a number of commercial practices. Specifically, the conditions in paragraphs (*b*) and (*c*), relating to the general partner's share in income and losses, are replaced by the condition in amended paragraph (*b*). As amended, paragraph (*b*) requires that the general partner's share in all income and losses of the partnership be determined on the basis of a single fixed percentage that is specified in the agreement governing the partnership and has not changed since the formation of the partnership. Nevertheless, as amended, paragraph (*b*) permits the general partner's share to vary from this fixed percentage in the following circumstances:

- Subparagraph (*b*)(i) allows the share to be less than the fixed percentage for income and losses from investments in specified properties. This replicates the exception set out in the existing paragraph (*b*).

- Pursuant to subparagraphs (*b*)(ii) and (iii), the share may be less than the fixed percentage to allow the limited partners to receive, in priority to other distributions, amounts not exceeding their contributed capital and a reasonable rate of return on that contributed capital, determined in accordance with the agreement governing the partnership.

- Pursuant to subparagraph (*b*)(iv), the share may be more than the fixed percentage to allow the general partner to receive amounts, in priority to other distributions, to compensate for previous reductions in the general partner's share resulting from priority distributions to limited partners as a return on their contributed capital as permitted under subparagraph (*b*)(ii).

The QLP definition is also amended so that the condition relating to the interests of the limited partners, currently set out in paragraph (*d*), will henceforth be in amended paragraph (*c*). As amended, this paragraph gives more flexibility by limiting the requirement that the units determining the interests of the limited partners be identical to the following characteristics: (i) the terms governing the obligations of the limited partners to contribute capital to the partnership; and

(ii) the terms governing the rights of the limited partners to receive distributions from the partnership.

Paragraph (*d*) of the QLP definition is also amended to require that the share of the limited partners in any income or loss of the partnership be determined in accordance with rules stipulated in the agreement governing the QLP, and that the share allocated in respect of any particular income or loss be identical for all units held by limited partners. However, this paragraph allows an exception when, at any particular time, the amount of capital contributed by a particular limited partner exceeds the amount of capital required by the general partner to be contributed by all limited partners. In these circumstances, any income or loss from a particular specified property (as newly defined in subsection 5000(7)) that is attributable to the investment of the excess contributed by the particular partner may be allocated entirely to the particular partner.

Lastly, the QLP definition is amended to allow a QLP to invest, after 2002, in another QLP (referred to as "investment partnership" for the purposes of this paragraph) as a limited partner. However, under amended subsection 5000(1.4), such an investment will qualify as non-foreign property for the investing QLP only in proportion to the non-foreign property held by the investment partnership. This investment is permitted by virtue of new subparagraph (*f*)(iv.1) of the QLP definition. This subparagraph also provides for a grace period for situations in which a QLP has invested in an investment partnership that, subsequently, ceases to be a QLP. In such instances, the investing partnership does not lose its status as a QLP if it disposes of the investment by the end of the third month following the month in which the investment partnership ceased to be a QLP.

Section 5000 is also amended by adding a definition "specified property" to subsection (7), which replicates the properties described in the definition "specified property" in subsection 5100(1). Consequential changes are made, where the expression "specified property" is used in section 5000, to eliminate references to subsection 5100(1). Finally, the definition "limited unit" in subsection 5000(7) is amended to refer to paragraph (*c*), rather than paragraph (*d*), of the QLP definition. This amendment is purely consequential to the amendments to the QLP definition.

Most of the amendments to section 5000 apply after 2002. The amendments to the definition "qualified limited partnership" in subsection 5000(7) apply in determining if a partnership is, at any time after 2002, a QLP. This is particularly relevant for a partnership that was established before 2003, since it establishes that it is the conditions in the modified QLP definition (rather than in the existing definition) that must be satisfied at all times since the formation of

the partnership, in order for the partnership to be a QLP at any time after 2002. This will enable, for example, existing partnership that did not have QLP status to qualify as a QLP provided it meets the revised definition.

**Prescribed Amounts and Areas**

ITR
7308(4)

Subsection 7308(4) of the Regulations applies for the purpose of determining the minimum amount that an annuitant under a RRIF is required to withdraw each year from the fund. In general, the minimum amount for a year is the fair market value of the RRIF assets at the beginning of the year, multiplied by a prescribed factor corresponding to the attained age of the RRIF annuitant (or, on election, the annuitant's spouse or common-law partner). The factors are set out in the table contained in subsection 7308(4).

Subsection 7308(4) is amended so that the factors also apply for the purpose of determining the minimum amount in connection with the new variable benefit under money purchase provisions of registered pension plans (RPPs). For details, refer to the commentary on section 8506.

This amendment applies after 2003.

**Pension Adjustments, Past Service Pension Adjustments, Pension Adjustment Reversals and Prescribed Amounts**

ITR
Part LXXXIII

Part LXXXIII of the Regulations provides rules for calculating pension adjustments, past service pension adjustments, pension adjustment reversals and other prescribed amounts. These amounts impact on the determination of an individual's RRSP deduction room.

**Definitions**

ITR
8300(1)

**"excluded contribution"**

Certain amounts transferred to an RPP are defined in subsection 8300(1) of the Regulations to be "excluded contributions". An excluded contribution is disregarded in determining pension credits

under a money purchase provision or under a defined benefit provision of a specified multi-employer plan.

The definition is amended to add to the list of excluded contributions an amount that was transferred to an RPP in accordance with new subsection 146.3(14.1) of the Act. Subsection 146.3(14.1) permits the direct transfer of an amount from an annuitant's RRIF to a money purchase provision of an RPP for the benefit of the annuitant, provided the annuitant was previously a member of the RPP.

This amendment applies after 2003.

**Normalized Pension**

ITR
8303(5)

Section 8303 of the Regulations provides rules for determining the past service pension adjustment (PSPA) of an individual for a year. A PSPA arises when benefits are provided to an individual under a defined benefit provision of an RPP on a past service basis, such as by upgrading existing benefits or by crediting additional years of pensionable service. PSPAs reduce an individual's RRSP deduction room.

In general terms, the PSPA is the total of the additional pension credits that would have been determined for each past service year if the past service benefits had been provided to the individual on a current service basis. In recalculating the pension credits, subsection 8303(5) provides that various benefit increases are to be excluded, thus reducing the PSPA otherwise determined.

The benefit exclusion in paragraph 8303(5)(*f*) applies where the benefit formula includes a flat benefit component. It excludes benefits arising from an increase in the flat benefit rate to the extent of the percentage increase in the average wage from the preceding year to the current year. It applies only to the first flat benefit rate increase each year.

The most common application of the exclusion provided for in paragraph 8303(5)(*f*) would be with respect to members of earnings-related plans whose earnings are large enough that their benefits are capped by the defined benefit limit. The defined benefit limit, which is defined in subsection 8500(1) as the greater of $1,722.22 and 1/9 of the "money purchase limit" (as defined in subsection 147.1(1) of the Act), is scheduled to be indexed to average wage growth starting in 2006. (This is by virtue of the fact that the money purchase limit, which will prevail after 2003, is indexed to average wage growth

after 2005.) By virtue of paragraph 8303(5)(*f*), no PSPA will be required to be reported for members whose benefits are increased annually as a result of the indexing of the defined benefit limit.

The defined benefit limit is also increased from $1,722 to $1,833 for 2004 and is scheduled to be further increased to $2,000 for 2005. (These amounts equal 1/9 of the money purchase limits of $16,500 and $18,000 for 2004 and 2005, respectively.) However, to the extent that average wage growth is less than the percentage increase in the defined benefit limit in these two years, paragraph 8303(5)(*f*) would not serve to fully exclude resulting benefit increases from PSPA. To avoid this result, new paragraph 8303(5)(*f*.1) is introduced to provide an exclusion for such flat benefit rate increases. This will ensure that no PSPA will be required to be reported for members whose benefits are increased simply as a result of the increases to the defined benefit limit in these two years.

If a plan's existing flat benefit rate is less than the defined benefit limit for a year of past service, no exclusion is provided under new paragraph 8303(5)(*f*.1) for that portion of the increase in the flat benefit rate that is required to bring the rate up to the defined benefit limit for that year. For example, if a plan's flat benefit rate were increased from $1,500 to $1,833 in 2004, paragraph 8303(5)(*f*.1) would not exclude that portion of the increase that is required to bring the rate up to the defined benefit limit for the year of past service. In other words, of the $333 benefit increase in respect of prior years, only $111 (= $1,833 - $1,722) would be excluded.

Paragraph 8303(5)(*f*.1) provides no relief for plans that are not amended until after 2005 to reflect the higher defined benefit limit. Furthermore, if a plan sponsor waits until 2005 to amend the plan to reflect the higher defined benefit limit, only partial relief will be provided for benefits in respect of 2004. This is illustrated in the example at the end of the commentary on this paragraph.

As with the exclusion in paragraph 8303(5)(*f*), paragraph 8303(5)(*f*.1) applies only with respect to the first flat benefit rate increase each year. Further, the exclusion applies only if a single flat benefit rate enters into the determination of the member's post-1989 lifetime retirement benefits, except as permitted in writing by the Minister of National Revenue. In the case of multiple flat benefit rates, it is expected that the Minister would generally permit the exclusion to apply as long as it would not result in a widening of the scope of the exclusion.

*Example*

*In January 2002, Owen joined a defined benefit RPP providing benefits of 2% of best average earnings per year of service. The maximum pension limit incorporated in the plan terms refers only to the current $1,722 defined benefit limit, without including any future increases. Owen's annual salary for 2002 to 2004 was $110,000, which gave rise to a pension credit of $14,900 for each year (= ($1,722 x 9) - $600).*

*In January 2005, the plan sponsor amends the plan to replace the $1,722 limit with "$2,000 or such other amount as may be permitted under the Income Tax Act". Since this amendment has the effect of increasing Owen's past service benefits, it is necessary to determine a PSPA.*

*The PSPA is the total of the additional pension credits that would have been determined for each of 2002, 2003 and 2004 if Owen's benefits had accrued on the basis of a $2,000 plan limit for each pension credit year and if benefits described in new paragraph 8303(5)(f.1) were excluded.*

*In recalculating the pension credits for 2002 and 2003, the full amount of the $278 benefit increase is excluded, since the plan's flat benefit rate in those years reflected the defined benefit limit for those years. However, in recalculating the 2004 pension credit, only $167 of the benefit increase is excluded, since the remaining $111 was required to bring the plan's existing flat benefit rate of $1,722 up to the defined benefit limit of $1,833 for that year.*

*Therefore, Owen's PSPA associated with the plan amendment is $1,000 (= $111.11 x 9). This result is consistent with the fact that the amount of RRSP deduction room that became available to Owen in relation to his 2004 earnings was $1,000 higher than it would have been had the 2004 pension credit been determined on the basis of an $1,833 plan limit.*

## Pension Credits and Prescribed Amounts for Certain Unregistered Retirement Arrangements

ITR
8308.1 to 8309

Sections 8308.1 to 8309 of the Regulations set out rules for determining pension credits and prescribed amounts for individuals who participate in foreign pension plans and other unregistered retirement arrangements. These amounts reduce the participant's RRSP deduction room.

These sections provide special transitional rules for determining pension credits from 1996 to 2003 and for determining prescribed amounts from 1997 to 2004. The intent of these rules is that, during those years in which the RRSP dollar limit was scheduled to be less than $15,500, high-income participants would lose all or part of the new RRSP deduction room that would otherwise have become available to them in those years by virtue of the $600 PA offset.

These sections are being amended so that the special rules cease to apply one year earlier than previously scheduled (that is, the rules will not apply in determining 2003 pension credits and 2004 prescribed amounts). These amendments are consequential to amendments to the Act, which provided for increases to the RRSP dollar limit earlier than previously scheduled.

**Registered Pension Plans**

ITR
Part LXXXV

Part LXXXV of the Regulations sets out conditions that must be satisfied in order for a pension plan to be registered under the Act.

**Interpretation**

ITR
8500(7)

Subsection 8500(7) of the Regulations deems the allocation of surplus and forfeited amounts to an individual under a money purchase provision of an RPP to be a contribution made on behalf of the individual for the purposes of a number of provisions in Part LXXXV that depend on whether money purchase contributions are made on behalf of an individual.

Subsection 8500(7) is amended so that the deeming provision also applies for the purpose of new paragraph 8506(2)(*c*.1), which prohibits money purchase contributions from being made on behalf of a member at any time after the calendar year in which the member turns 69 years of age.

This amendment applies after 2003.

**Conditions for Registration**

ITR
8501(1)

Subsection 8501(1) of the Regulations lists the prescribed conditions for the registration of a pension plan. The prescribed conditions include, in paragraph 8501(1)(*e*), a condition that enables the Minister to refuse to register a plan where it is apparent that there may, immediately or at a future date, be non-compliance with certain specified conditions that are not prescribed conditions for registration.

Paragraph 8501(1)(*e*) is amended to add a reference to new subsection 8506(4), which provides a minimum payment rule applicable to money purchase RPPs that offer the new RRIF-like benefit option to its members. To comply with this prescribed condition as it relates to subsection 8506(4), such a plan would have to include a term requiring that the amount of variable benefits to be paid each year in respect of a member's account not be less than the minimum amount specified for the purpose of that subsection. For more details, refer to the commentary on subsections 8506(4) to (6).

This amendment applies after 2003.

**Conditions Applicable to Registered Pension Plans**

ITR
8501(2)

Subsection 8501(2) of the Regulations lists conditions that apply to a pension plan that has been registered. If an RPP fails to comply with any of these conditions, it becomes a revocable plan and, pursuant to subsections 147.1(11) to (13) of the Act, its registration may be revoked.

Paragraph 8501(2)(*c*) is amended, effective after 2003, to add a reference to the conditions in new paragraphs 8506(2)(*c*.1) and (*i*) relating to money purchase provisions. For details, refer to the commentary on those paragraphs.

**Permissible Contributions**

ITR
8502(*b*)

Section 8502 of the Regulations lists conditions that apply for the registration of a pension plan. Paragraph 8502(*b*) lists the contributions that are permitted to be made to an RPP. The list

includes transfers from other registered plans in accordance with any of subsections 146(16) (transfer from an RRSP), 147(19) (transfer from a DPSP) and 147.3(1) to (8) of the Act (transfer from an RPP).

Paragraph 8502(*b*) is amended to expand the list of permissible contributions to include transfers from a RRIF in accordance with new subsection 146.3(14.1) of the Act. Subsection 146.3(14.1) permits the direct transfer of an amount from an annuitant's RRIF to a money purchase provision of an RPP for the benefit of the annuitant, provided the annuitant was previously a member of the RPP.

This amendment applies after 2003.

**Payment of Pension**

ITR
8502(*e*)

Paragraph 8502(*e*) of the Regulations requires an RPP to provide that retirement benefits will begin to be paid to each member no later than the end of the year in which the member turns 69 years of age.

Paragraph 8502(*e*) is amended to extend the pension commencement date by one year in the case of retirement benefits provided under a money purchase provision in accordance with new paragraph 8506(1)(*e*.1). That paragraph allows money purchase RPPs to provide retirement benefits to members in a manner similar to that permitted under a RRIF. This amendment is intended to provide consistency with the maximum deferral permitted under the RRSP/RRIF rules. Specifically, since RRSP annuitants have until the year in which they turn 69 years of age to convert their RRSP into a RRIF and minimum withdrawals under a RRIF are required to begin only in the year following the year in which the RRIF is set up, an RRSP annuitant can effectively defer receipt of retirement income to the year in which they turn 70 years of age. Paragraph 8502(*e*) is also amended for greater clarity.

These amendments apply after 2003.

**Money Purchase Provisions**

ITR
8506

Section 8506 of the Regulations describes the benefits that may be provided under a money purchase provision of an RPP and contains conditions that apply to a plan that has a money purchase provision.

## Guarantee Period

ITR
8506(1)(*c*)

Paragraph 8506(1)(*c*) of the Regulations allows retirement benefits payable under a money purchase provision of an RPP to be guaranteed for up to 15 years. The guarantee benefits must not exceed the retirement benefits that would have been payable to the member if the member were alive.

Paragraph 8506(1)(*c*) is amended so that any variable benefits (retirement benefits permissible under new paragraph 8506(1)(*e*.1)) that were payable to the member are ignored in determining the limit on the amount of guarantee benefits that may be provided. This will be relevant where a member's retirement benefits were provided partially by means of an annuity held by the plan and partially by means of the payment of variable benefits from the member's account. This amendment applies after 2003.

## Post-retirement Survivor Benefits

ITR
8506(1)(*d*)

Paragraph 8506(1)(*d*) of the Regulations permits an RPP to provide for the payment of survivor benefits under a money purchase provision to a spouse or common-law partner or former spouse or common-law partner of a member who dies after beginning to receive retirement benefits. The survivor benefits, together with any benefits payable under a guarantee, must not exceed the retirement benefits that would have been payable to the member if the member were alive.

Paragraph 8506(1)(*d*) is amended so that any variable benefits that were payable to the member are ignored in determining the limit on the amount of survivor benefits that may be provided. This amendment is consistent with the amendment to paragraph 8506(1)(*c*). It applies after 2003.

## Variable Benefits

ITR
8506(1)(*e*.1)

New paragraph 8506(1)(*e*.1) of the Regulations permits an RPP to provide retirement benefits (referred to as "variable benefits") to a member under a money purchase provision, and to beneficiaries of

the member after the member's death, by means of payments from the member's account. This is in contrast to retirement benefits described in paragraphs 8506(1)(*a*) to (*e*), which by virtue of paragraph 8506(2)(*g*) must generally be provided by means of an annuity purchased from a licensed annuities provider. Paragraph 8506(1)(*e*.1) is intended to allow money purchase benefits to be provided in the same manner as is permitted under a RRIF.

The amount of variable benefits payable each year from the member's account must not be less than the minimum amount determined in accordance with rules set out in subsections 8506(5) and (6). The minimum amount is determined on the basis of the balance in the member's account at the beginning of each year and the attained age of either the member or the member's spouse or common-law partner. These rules are similar to the minimum withdrawal rules that apply to RRIFs. The calculation of the minimum amount is illustrated in the examples following the commentary on subsection 8506(7).

As noted, variable benefits can be provided to beneficiaries of a member after the death of the member. Where the beneficiary is a specified beneficiary of the member, the payment of variable benefits can continue until the end of the calendar year in which the specified beneficiary dies. The expression "specified beneficiary" of a member, which is defined in new subsection 8506(7), is restricted to the surviving spouse or common-law partner of the member and requires that there be a written designation of the individual as specified beneficiary. The payment of variable benefits to other beneficiaries (which can include a spouse or common-law partner who has not been designated as a specified beneficiary) must cease no later than the end of the calendar year following the year in which the member dies. Paragraphs 8506(2)(*h*) and (*i*) require that the balance in the member's account remaining after variable benefits cease to be payable be paid as soon as is practicable.

The characterization of payments from a member's money purchase account as periodic payments (and, thus, retirement benefits as defined in subsection 8500(1)) for the purposes of paragraph 8506(1)(*e*.1) may not always be straightforward. However, where a money purchase plan contemplates post-retirement benefits being paid from a member's account as permitted under paragraph 8506(1)(*e*.1) and, as such, contains terms setting out minimum amounts which must be withdrawn at least annually, payments made in accordance with those terms would be considered to be periodic in nature. Although all other payments made from a member's account would generally be considered to be lump sum, rather than periodic, there may be exceptions. For example, if a member establishes a pattern of payments in excess of the minimum required under the plan terms (by electing to receive, for example, annual payments equal to the

maximum permitted under governing pension benefits legislation), any excess payments fitting this pattern would also be considered to be periodic payments.

The characterization of payments as periodic or lump sum is relevant, in particular, for purposes of the transfer provisions in section 147.3 of the Act. These provisions allow the tax-free transfer of funds between registered plans only where the amount transferred constitutes a lump sum. This is illustrated in example 3 following the commentary on subsection 8506(7). The characterization is also relevant for purposes of determining withholding tax on pension payments to non-residents. Many of Canada's income tax treaties provide for a reduced rate of withholding tax for periodic pension payments.

New paragraph 8506(1)(*e*.1) applies after 2003.

**Payment from Account After Death**

ITR
8506(1)(*g*)

Paragraph 8506(1)(*g*) of the Regulations permits an RPP to provide for the payment of lump sum amounts under a money purchase provision to beneficiaries of a member where the member dies before beginning to receive retirement benefits. These payments cannot exceed the balance in the member's account.

Paragraph 8506(1)(*g*) is amended to allow lump sum payments to be made from the member's account to beneficiaries of the member regardless of whether the member had begun to receive retirement benefits. This ensures the balance in the money purchase account of a deceased member who had been receiving variable benefits may be paid to the member's beneficiaries. This amendment applies after 2003.

**Contributions Not Permitted**

ITR
8506(2)(*c*.1)

New paragraph 8506(2)(*c*.1) of the Regulations generally prohibits a contribution or transfer to a money purchase provision of an RPP on behalf of a member at any time after the calendar year in which the member turned 69 years of age. This prohibition also applies to the allocation of amounts to a member that are attributable to forfeited amounts or surplus, since such amounts are deemed by subsection 8500(7) to be contributions for the purpose of this rule.

Exceptions to this prohibition are provided for post-age 69 transfers that are made in accordance with subsection 146.3(14.1) of the Act (transfers from a RRIF), subsection 147.3(1) of the Act (lump sum transfers from a money purchase provision) and subsection 147.3(4) of the Act (lump sum transfers from a defined benefit provision) and similar intra-plan transfers.

Paragraph 8506(2)(*c*.1), which applies after 2003, is added for greater certainty and does not reflect a change in policy.

**Allocation of Earnings**

ITR
8506(2)(*e*)

Paragraph 8506(2)(*e*) of the Regulations requires an RPP containing a money purchase provision to allocate earnings of the plan (other than earnings attributable to forfeited amounts or a surplus under the provision) on a reasonable basis and no less frequently than annually to plan members.

Paragraph 8506(2)(*e*) is amended to require plan earnings be allocated on a monthly basis, as a minimum. This is intended to bring the earnings allocation rule more in line with current practice. This amendment applies after the month that includes Announcement Date.

**Retirement Benefits**

ITR
8506(2)(*g*)

Paragraph 8506(2)(*g*) of the Regulations requires that retirement benefits payable under a money purchase provision of an RPP be provided either by means of annuities purchased from a licensed issuer of annuities or under an arrangement acceptable to the Minister.

Paragraph 8506(2)(*g*) is amended in three ways. First, it is amended so that it does not apply to variable benefits permissible under new paragraph 8506(1)(*e*.1). Variable benefits are simply provided by means of payments from a member 's account based on the account balance and the attained age of the member or the member's spouse or common-law partner.

The second amendment to paragraph 8506(2)(*g*) removes the discretionary authority for the Minister to accept other arrangements. However, grandfathering is provided for plans that do not provide retirement benefits by means of annuities purchased from a licensed

annuities provider, if the arrangement under which retirement benefits are provided was accepted by the Minister before Announcement Date and the arrangement continues to remain acceptable.

Finally, paragraph 8506(2)(*g*) is amended by replacing some of the existing words in the paragraph with the expression "licensed annuities provider", which is defined in subsection 248(1) of the Act. This amendment does not represent a change in policy.

These amendments apply after 2003.

**Undue Deferral of Payment**

ITR
8506(2)(*h*)

Paragraph 8506(2)(*h*) of the Regulations requires that lump sums payable under a money purchase provision of an RPP after the death of a member be paid as soon as practicable after the death of the member.

Paragraph 8506(2)(*h*) is amended to provide an exception for lump sum payments that are payable after the death of the member's specified beneficiary, as defined in subsection 8506(7). In general, the specified beneficiary of a member is the surviving spouse or common-law partner of a deceased member to whom variable benefits (as permitted under new paragraph 8506(1)(*e*.1)) continue to be paid from the member's account. This amendment ensures that, after the death of the specified beneficiary, the balance in the member's account may be paid out of the plan without contravening the condition in paragraph 8506(2)(*h*).

This amendment applies after 2003.

ITR
8506(2)(*i*)

New paragraph 8506(2)(*i*) of the Regulations is similar to paragraph 8506(2)(*h*). It requires that lump sums payable under a money purchase provision of an RPP after the death of a specified beneficiary of a member be paid as soon as practicable after the death of the specified beneficiary. Paragraph 8506(2)(*i*) applies after 2003.

**Non-payment of Minimum Amount - Plan Revocable**

ITR
8506(4)

New subsection 8506(4) of the Regulations applies to RPPs containing a money purchase provision that provides for the payment of variable benefits to members and beneficiaries of members. Variable benefits are retirement benefits permissible under new paragraph 8506(1)(*e*.1).

Subsection 8506(4) provides that an RPP becomes a revocable plan at the beginning of a calendar year if the total amount of variable benefits paid from a member's account in the year is less than the minimum amount for the account for the year. The minimum amount is determined in accordance with rules set out in subsections 8506(5) and (6). For details, refer to the commentary on those subsections.

Subsection 8506(4) applies after 2003.

**Minimum Amount**

ITR
8506(5)

Subsection 8506(5) of the Regulations defines the minimum amount for a member's account under a money purchase provision of an RPP with reference to a calendar year. In general, the minimum amount for a calendar year is determined on the basis of the balance in the member's account at the beginning of the year and the attained age of the member (or the member's spouse or common-law partner). Examples 1 to 3 following the commentary on subsection 8506(7) illustrate the operation of the minimum amount rules.

The definition applies for the purposes of subsection 8506(4) and paragraph 8506(1)(*e*.1) in determining the minimum payout schedule for variable benefits under a member's money purchase account. This definition generally corresponds to the definition "minimum amount" in subsection 146.3(1) of the Act that applies in determining minimum withdrawals under a RRIF.

More specifically, except as noted below, the minimum amount for a member's account for a calendar year is determined by multiplying the balance in the member's account at the beginning of the year by a designated factor corresponding to the attained age of the member or, in certain circumstances, the member's spouse or common-law partner. The designated factors are set out in the table in amended subsection 7308(4) of the Regulations.

The account balance must be determined in a manner that reasonably reflects the fair market value of the property of the plan held in connection with the account. Where, in addition to variable benefits, the plan also provides for a portion of the member's retirement benefits to be provided by means of an annuity purchased from a licensed annuities provider, the value of the annuity is to be disregarded in determining the account balance. Similarly, where a portion of the member's retirement benefits are provided under a grandfathered arrangement as described in the commentary to paragraph 8506(2)(*g*), the property held in connection with those retirement benefits is also disregarded. In both cases, the disregard applies only to the extent that retirement benefits had begun to be paid before the beginning of the year and remain payable in the year.

For years in which the member is alive, the minimum amount can be based on the age of either the member or the member's spouse or common-law partner. In order to use the age of the member's spouse or common-law partner for a given year, the member must advise the plan administrator in writing before the beginning of the year.

Changes to the payout schedule may be made to reflect changes in family circumstances. For example, a member who marries a younger spouse after having begun to receive variable benefits may wish to change the payout schedule so that the minimum amount is based on the age of his or her spouse. Assuming the pension plan permits, the member can effect such a change simply by making a written request to the plan administrator. The revised payout schedule would apply beginning in the year following the year in which the request was made.

The payout schedule that applied while the member was alive continues to apply after the member's death with respect to any variable benefits that remain payable to a beneficiary (other than the specified beneficiary) of the member for the year of death and the following year. Where the member's surviving spouse or common-law partner is entitled to receive variable benefits as the member's specified beneficiary, the payout schedule must be revised so that the minimum amount is based on the age of the spouse or common-law partner. For further details, refer to the commentary on subsection 8506(7) and examples 1 and 2 following that subsection.

The determination of the minimum amount under new subsection 8506(5) is subject to new subsection 8506(6). Under that subsection, the minimum amount for years prior to the year in which the member

(or, after the death of the member, the specified beneficiary) turns 70 years of age is defined to be nil. This is intended to provide consistency with the maximum deferral permitted under the RRSP/RRIF rules.

Subsection 8506(5) applies after 2003.

**When Minimum Amount is Nil**

ITR
8506(6)

To provide consistency with the maximum deferral permitted under the RRSP/RRIF rules, new subsection 8506(6) of the Regulations (in conjunction with amended subparagraph 8502(*e*)(i)) ensures that a member is not required to begin receiving variable benefits from their money purchase account until the year in which the member turns age 70. It does so by defining the minimum amount for a member's money purchase account for calendar years before the calendar year in which the member turns 70 years of age to be nil. Similar treatment is provided with respect to the specified beneficiary of a deceased member. The application of this subsection is illustrated in example 1 following the commentary on subsection 8506(7).

Subsection 8506(6) applies after 2003.

**Specified Beneficiary**

ITR
8506(7)

New subsection 8506(7) of the Regulations defines the "specified beneficiary" of a member in relation to a money purchase provision and with reference to a calendar year as the surviving spouse or common-law partner of the member. The specified beneficiary of a member is entitled to receive variable benefits from the member's account after the member's death and throughout their lifetime in accordance with paragraph 8506(1)(*e*.1).

To qualify as the specified beneficiary for a given year, the member or the member's legal representative must provide a written designation of the individual as the specified beneficiary to the plan administrator before the beginning of the year. Further, an individual cannot be a specified beneficiary any earlier than the year following the year in which the member dies. This condition, which applies primarily for mechanical reasons, ensures that the minimum amount for the year of the member's death is determinable at the beginning the year and does not change as a result of the member's death. It is

important to note that the surviving spouse or common-law partner of a member may receive variable benefits for the remainder of the year in which the member dies and for the following year without having to qualify as the member's specified beneficiary. This is by virtue of the fact that paragraph 8506(1)(*e*.1) allows variable benefits to continue to be paid after the death of the member to any beneficiary of the member until the end of the year following the year of death.

The operation of the minimum amount rules is illustrated in the following examples.

*Example 1*

*Galen turns 69 years of age in 2005 and must begin receiving variable benefits starting in 2006. When Galen retired in 2004, he advised the plan administrator to use the age of his younger spouse, Carole, in determining the minimum payout schedule for his account. He also designated Carole as his specified beneficiary for years after his death so that she could continue to receive payments from the account throughout her lifetime in the event that he dies before her.*

*At the beginning of 2006, Carole is 66 years of age and the account balance is $320,000. The minimum amount for 2006 for Galen's account is $13,333 (= $320,000 x (1/(90- 66))). In accordance with the plan terms, the minimum amount is payable in equal monthly instalments over the course of the year.*

*Galen dies in October 2006. The remaining two instalments are paid to Carole. The minimum amount for 2007 is determined on the basis of Carole's age, as specified beneficiary for that year. Since Carole is less than 70 years of age, the minimum amount for 2007 is nil in accordance with subsection 8506(6).*

*Example 2*

*Anita dies in 2007 after having received variable benefits for two years. The minimum amount was based on Anita's age. When commencing to receive retirement benefits from the plan, Anita designated her spouse, Daniel (who is two years older), as her specified beneficiary, but only for years after the year following the year of her death. Thus, for the remainder of 2007 and for all of 2008, the retirement benefits payable to Daniel as beneficiary are based on the minimum payout schedule established for Anita. However, when Daniel starts receiving retirement benefits as specified beneficiary in 2009, the payout schedule is revised so that the minimum amount is based on his age.*

*Example 3*

*In September 2005, Clarke decides to transfer his money purchase funds to a RRIF. The balance at that time in Clarke's account is $180,000. The minimum amount for Clarke's account for 2005 is $15,000. Clarke has already received $10,000 from his account during the year. The maximum amount eligible for tax-free transfer under subsection 147.3(1) of the Act is $175,000 (= $180,000 - ($15,000 - $10,000)). The remaining $5,000 must be paid directly to Clarke.*

**PA Limits - 1996 to 2002**

ITR
8509(12)

Subsection 8509(12) of the Regulations contains a special transitional rule that ensures that a defined benefit RPP providing maximum benefits to higher-income members does not become revocable only because of the fact that pension adjustments are greater than the money purchase limit. The rules apply for those calendar years (1996 to 2003) in which the money purchase limit was scheduled to be less than $15,500.

Subsection 8509(12) is amended so that it does not apply for the 2003 calendar year. This amendment is consequential to an amendment to the Act, which provided for increases to the money purchase limit earlier than previously scheduled.

# APPENDIX B

# INSURERS

ITR
Part XXIV

Part XXIV of the *Income Tax Regulations* sets out special rules for the computation of an insurer's income.

Subsection 138(9) of the *Income Tax Act* requires resident multinational life insurers and non-resident insurers to include in computing their income from an insurance business carried on in Canada their gross investment revenue for the year derived from their designated insurance property.

Section 2411 of the Regulations prescribes an amount for the purpose of subsection 138(9) of the Act, which ensures that an insurer's net investment revenue from its designated insurance property is not less than the net investment revenue that would be determined from that property if the average rate of return on its designated assets of each class were equal to the average rate of return on all its investment property of that class. This prevents an insurer from understating its Canadian business income by designating assets in respect of its Canadian insurance business that produce lower investment returns than its assets not so designated.

Regulation 2411(3) sets out the computation of the minimum amount of net investment revenue that must be reported by an insurer for a taxation year. In general terms, the minimum net investment revenue is determined by multiplying the net investment revenue earned on the insurer's designated property by the ratio that the insurer's net investment revenue on all its investment property is of the value for the year of all its investment property. That ratio represents the average yield on the insurer's investment property. Multiplying the ratio by the value of the designated insurance property produces the average yield imputed to that property.

The descriptions of B and E in the formula in subsection 2411(3) of the Regulations are amended so that the total value of property described therein is determined without reference to any property described in paragraph (*i*) of the definition "Canadian investment property" in subsection 2400(1) of the Regulations. The description of H in that formula is similarly amended to exclude any property described in paragraph (*e*) of the definition "investment property" in

subsection 2400(1). As a result, due or accrued income that arises from designated insurance property and that was assumed in computing the Canadian reserve liabilities will not be taken into account in determining the average yield.

These amendments apply to taxation years that end after Announcement Date.

# APPENDIX C

## FOREIGN AFFILIATES

ITR
5902(1)

Section 5902 of the *Income Tax Regulations* applies where a corporation elects to treat proceeds of disposition of a share of a foreign affiliate as a dividend under subsection 93(1) of the *Income Tax Act*. Subsection 5902(1) of the Regulations computes a foreign affiliate's surplus accounts and the amount of a whole dividend used in applying subsection 5901(1) for the purposes of subsection 5900(1) of the Regulations.

Subsection 5902(1) is replaced with a new subsection that changes how the exempt surplus or exempt deficit, taxable surplus or taxable deficit, underlying foreign tax and net surplus is determined for the foreign affiliate of a corporation resident in Canada whose shares are disposed of and in respect of which disposition an election under subsection 93(1) or (1.2) of the Act is made by the corporation resident in Canada.

Under proposed subsection 5902(1), the surplus balances of the foreign affiliate of the corporation resident in Canada (the "disposed foreign affiliate") are to be computed using a new consolidation approach, which will take into account the surpluses and deficits of foreign affiliates, for the disposed foreign affiliate and any other foreign affiliate of the corporation resident in Canada in which the disposed foreign affiliate has an equity percentage.

As well, under proposed subsection 5902(1), the amount of an election in respect of a disposed share will be capped at the amount of the attributed net surplus in respect of the share determined under the rules in that new subsection.

New subsection 5902(1) provides that, in respect of a corporation resident in Canada, the following rules apply if, at a particular time, one or more shares (a "disposed share") of a class (the "specified class") of a particular foreign affiliate of the corporation resident in Canada is disposed of by a particular shareholder of the particular foreign affiliate and, because of an election made under subsection 93(1) or (1.2) of the Act in respect of that disposition, a dividend is deemed under subsection 93(1) or (1.2) of the Act to have been received on a disposed share at the time (the "dividend time") that is immediately before the particular time.

- New paragraph (*a*) deems the amount of the particular foreign affiliate's exempt surplus (the "consolidated exempt surplus"), at the time (in this subsection and also in section 5905, the "calculation time") that is immediately before the dividend time, to be the amount that would be its exempt surplus, at the calculation time, if:

    - the particular foreign affiliate and each other foreign affiliate of the corporation resident in Canada in which the particular foreign affiliate had, at the calculation time, an equity percentage (a "subsidiary affiliate"), had (except in determining under subparagraph 5902(1)(*a*)(iii) the consolidated net surplus in respect of the corporation resident in Canada), at the calculation time, no amount of exempt deficit, taxable surplus or taxable deficit,

    - the amount of the exempt surplus of the particular foreign affiliate were, immediately before the calculation time, increased by the particular foreign affiliate's proportionate share (determined below) of the exempt surplus of each subsidiary affiliate in which it has, immediately before the time that is immediately before the calculation time, a direct equity percentage if that exempt surplus in respect of the corporation resident in Canada were computed in the following manner:

        - the exempt surplus in respect of the corporation resident in Canada of the subsidiary affiliate were increased by the subsidiary affiliate's proportionate share of the exempt surplus of a foreign affiliate of the corporation resident in Canada in which the subsidiary affiliate has, immediately before the time that is immediately before the calculation time, a direct equity percentage; and

        - the exempt surplus in respect of the corporation resident in Canada of a subsidiary affiliate in which another subsidiary affiliate has a direct equity percentage, were increased before the increase in that other subsidiary affiliate's exempt surplus in respect of the corporation resident in Canada;

    - the proportionate share, at any time, of a foreign affiliate (the "calculating foreign affiliate") of the corporation resident in Canada, of the exempt surplus of another foreign affiliate (the "providing foreign affiliate") of the corporation resident in

Canada in which the calculating foreign affiliate has a direct equity percentage were equal to the proportion determined by the formula:

$$A/B$$

where

A is the amount of dividends that would be received, at that time, by the calculating foreign affiliate from the providing foreign affiliate if, at that time, the providing foreign affiliate had paid dividends on all of its shares and the total of those dividends were equal to its consolidated net surplus (determined assuming that the providing foreign affiliate were the particular foreign affiliate), or, where it does not have such a consolidated net surplus, its consolidated exempt surplus (determined assuming that the providing foreign affiliate were the particular foreign affiliate), at that time; and

B is the amount of the providing foreign affiliate's consolidated net surplus (determined assuming that the providing foreign affiliate were the particular foreign affiliate), or, where it does not have such a consolidated net surplus, its consolidated exempt surplus (determined assuming that the providing foreign affiliate were the particular foreign affiliate), at that time; and

- in determining the particular foreign affiliate's consolidated exempt surplus in respect of the corporation resident in Canada,
  - no amount were included, directly or indirectly, in respect of exempt surplus in respect of the corporation resident in Canada of the particular shareholder of the particular foreign affiliate that disposed of the disposed share, and
  - no amount were included, directly or indirectly, in respect of exempt surplus in respect of the corporation resident in Canada of the particular foreign affiliate or any subsidiary affiliate more than once.

- New paragraph (*b*) deems the amount of the particular foreign affiliate's exempt deficit (the "consolidated exempt deficit") in respect of the corporation resident in Canada, at the calculation time, to be the amount that would be its exempt deficit in respect of the corporation resident in Canada, at that time, if:

- the particular foreign affiliate and each subsidiary affiliate had (except for the purpose of determining consolidated net surplus), at the calculation time, no amount of exempt surplus, taxable surplus or taxable deficit, in respect of the corporation resident in Canada,

- the amount of the exempt deficit in respect of the corporation resident in Canada of the particular foreign affiliate, were, immediately before the calculation time, increased by the particular foreign affiliate's proportionate share (determined below) of the exempt deficit in respect of the corporation resident in Canada of each subsidiary affiliate in which it has, immediately before the calculation time, a direct equity percentage, if that exempt deficit in respect of the corporation resident in Canada were, immediately before the calculation time, determined in the following manner:

  - the exempt deficit, in respect of the corporation resident in Canada, of the subsidiary affiliate, were increased by the subsidiary affiliate's proportionate share (determined below) of the exempt deficit in respect of the corporation resident in Canada of a foreign affiliate of the corporation resident in Canada in which the subsidiary affiliate has, immediately before the time that is immediately before the calculation time, a direct equity percentage; and

  - the exempt deficit in respect of the corporation resident in Canada, of a subsidiary affiliate in which another subsidiary affiliate has a direct equity percentage, were increased before the increase in that other subsidiary affiliate's deficit in respect of the corporation resident in Canada;

- the proportionate share (referred to above), at any time, of a calculating foreign affiliate of the exempt deficit in respect of the corporation resident in Canada of a providing foreign affiliate is equal to the proportion determined by the following formula:

$$A/B$$

where

A is the amount of dividends that would be received by the calculating foreign affiliate from the providing foreign affiliate if, at that time, the providing foreign affiliate had paid dividends on all of its shares and the total amount of those dividends were equal to its consolidated net surplus (determined assuming that the providing foreign affiliate

were the particular foreign affiliate) in respect of the corporation resident in Canada, or, where it does not have such a consolidated net surplus, its exempt deficit (determined assuming that the providing foreign affiliate were the particular foreign affiliate) in respect of the corporation resident in Canada, at that time; and

B is the amount of the providing foreign affiliate's consolidated net surplus (determined assuming that the providing foreign affiliate were the particular foreign affiliate) in respect of the corporation resident in Canada, or, where it does not have such a consolidated net surplus, its consolidated exempt deficit (determined assuming that the providing foreign affiliate were the particular foreign affiliate), in respect of the corporation resident in Canada, at that time; and

- in determining the particular foreign affiliate's consolidated exempt deficit in respect of the corporation resident in Canada,

  • no amount were included, directly or indirectly, in respect of the exempt deficit in respect of the corporation resident in Canada of the particular shareholder of the particular foreign affiliate that disposed of the disposed share, and

  • no amount were included, directly or indirectly, in respect of the exempt deficit in respect of the corporation resident in Canada of the particular foreign affiliate or any subsidiary affiliate more than once.

• New paragraph (*c*) deems the amount of the particular foreign affiliate's taxable surplus and underlying foreign tax, in respect of the corporation resident in Canada (the "consolidated taxable surplus", and "consolidated underlying foreign tax", respectively), at the calculation time, to be the amount that would be its taxable surplus, and underlying foreign tax, in respect of the corporation resident in Canada, at that time, if:

- the particular foreign affiliate and each subsidiary affiliate had, at the calculation time, no amount of exempt surplus, exempt deficit or taxable deficit, in respect of the corporation resident in Canada,

- the amount of the taxable surplus and underlying foreign tax in respect of the corporation resident in Canada of the particular foreign affiliate, were, immediately before the calculation time, increased by the particular foreign affiliate's proportionate share (described below) of the taxable surplus or underlying foreign

tax in respect of the corporation resident in Canada of each subsidiary affiliate in which the particular foreign affiliate has, immediately before the calculation time, a direct equity percentage if that taxable surplus, and underlying foreign tax, in respect of the corporation resident in Canada were, immediately before the calculation time, determined in the following manner:

- the taxable surplus and underlying foreign tax, in respect of the corporation resident in Canada, of the subsidiary affiliate were increased by the subsidiary affiliate's proportionate share of the taxable surplus or underlying foreign tax, in respect of the corporation resident in Canada, of a foreign affiliate of the corporation resident in Canada in which the subsidiary affiliate had, immediately before the time that is immediately before the calculation time, a direct equity percentage; and

- the taxable surplus, and underlying foreign tax in respect of the corporation resident in Canada, of a subsidiary affiliate in which another subsidiary affiliate has a direct equity percentage, were increased before the increase in that other subsidiary affiliate's taxable surplus and underlying foreign tax, in respect of the corporation resident in Canada;

- the proportionate share, at any time, of a calculating foreign affiliate of the taxable surplus or underlying foreign tax of a providing foreign affiliate were equal to the proportion determined by the following formula:

$$A/B$$

where

A is the amount of dividends that would be received, at that time, by the calculating foreign affiliate from the providing foreign affiliate if, at that time, the providing foreign affiliate had paid dividends on all of its shares and the total of those dividends were equal to its consolidated net surplus (determined assuming that the providing foreign affiliate were the particular foreign affiliate), in respect of the corporation resident in Canada, or, where it does not have such a consolidated net surplus, its consolidated taxable surplus (determined assuming that the providing foreign affiliate were the particular foreign affiliate), in respect of the corporation resident in Canada, at that time, and

B is the amount of the providing foreign affiliate's consolidated net surplus (determined assuming that the providing foreign affiliate were the particular foreign affiliate), in respect of the corporation resident in Canada, or, where it does not have such a consolidated net surplus, its consolidated taxable surplus (determined assuming that the providing foreign affiliate were the particular foreign affiliate), in respect of the corporation resident in Canada, at that time, and

- in determining the particular foreign affiliate's consolidated taxable surplus, and consolidated underlying foreign tax,

  • no amount were included, directly or indirectly, in respect of the taxable surplus and underlying foreign tax in respect of the corporation resident in Canada, of the particular shareholder of the particular foreign affiliate that disposed of the disposed share, and

  • no amount were included, directly or indirectly, in respect of the taxable surplus and underlying foreign tax in respect of the corporation resident in Canada of the particular foreign affiliate or any subsidiary affiliate more than once.

• New paragraph (*d*) deems the amount of the particular foreign affiliate's taxable deficit (the "consolidated taxable deficit"), in respect of the corporation resident in Canada, at the calculation time, to be the amount that would be its taxable deficit, at that time if

- the particular foreign affiliate and each subsidiary affiliate had (except in determining consolidated net surplus), at the calculation time, no amount of exempt surplus, exempt deficit or taxable surplus, in respect of the corporation resident in Canada,

- the amount of the taxable deficit in respect of the corporation resident in Canada of the particular foreign affiliate were, immediately before the time that is immediately before the calculation time, increased by an amount equal to the particular foreign affiliate's proportionate share (described below) of the taxable deficit in respect of the corporation resident in Canada of each subsidiary affiliate in which it has, immediately before the calculation time, a direct equity percentage, if that taxable deficit in respect of the corporation resident in Canada were, at the particular time, determined in the following manner

- the taxable deficit of the subsidiary affiliate were increased by the subsidiary affiliate's proportionate share of the taxable deficit of a foreign affiliate of the corporation resident in Canada in which the subsidiary affiliate had, immediately before the particular time, a direct equity percentage, and

- the taxable deficit of a subsidiary affiliate in which another subsidiary affiliate has a direct equity percentage were increased before the increase in that other subsidiary affiliate's taxable deficit,

- the proportionate share, at any time, of a calculating foreign affiliate of the corporation resident in Canada, of the taxable deficit of a providing foreign affiliate were equal to the proportion determined by the following formula:

$$A/B$$

where

A is the amount of dividends that would be received, at that time, by the calculating foreign affiliate from the providing foreign affiliate if, at that time, the providing foreign affiliate had paid dividends on all of its shares and the total amount of those dividends were equal to its consolidated net surplus (determined assuming that the providing foreign affiliate were the particular foreign affiliate) in respect of the corporation resident in Canada, or, where it does not have such a consolidated net surplus, its consolidated taxable deficit (determined assuming that the providing foreign affiliate were the particular foreign affiliate), at that time, and

B is the amount of the providing foreign affiliate's consolidated net surplus (determined assuming that the providing foreign affiliate were the particular foreign affiliate) in respect of the corporation resident in Canada, or, where it does not have such a consolidated net surplus, its consolidated taxable deficit (determined assuming that the providing foreign affiliate were the particular foreign affiliate) in respect of the corporation resident in Canada, at that time, and

- in determining the particular foreign affiliate's consolidated taxable deficit in respect of the corporation resident in Canada,

- no amount were included, directly or indirectly, in respect of taxable deficit, in respect of the corporation resident in

Canada, of the particular shareholder of the particular foreign affiliate that disposed of the disposed share, and

  - no amount were included, directly or indirectly, in respect of the taxable deficit, in respect of the corporation resident in Canada, of the particular foreign affiliate or any subsidiary affiliate more than once.

- New paragraph (*e*) provides, in applying subsection 5901(1) to subsection 5900(1), and for the purpose of paragraph (*f*), that,

  - the particular foreign affiliate's exempt surplus in respect of the corporation resident in Canada, immediately before the dividend time, is deemed to be the amount, if any, by which the particular foreign affiliate's consolidated exempt surplus exceeds the amount of the particular foreign affiliate's consolidated exempt deficit, in respect of the corporation resident in Canada, at that time (or, if there is no such excess, nil),

  - the particular foreign affiliate's exempt deficit in respect of the corporation resident in Canada, immediately before the dividend time, is deemed to be the amount, if any, by which the particular foreign affiliate's consolidated exempt deficit exceeds the amount of the particular foreign affiliate's consolidated exempt surplus, in respect of the corporation resident in Canada, at that time (or, if there is no such excess, nil),

  - the particular foreign affiliate's taxable surplus in respect of the corporation resident in Canada, immediately before the dividend time, is deemed to be the amount, if any, by which the particular foreign affiliate's consolidated taxable surplus exceeds the amount of the particular foreign affiliate's consolidated taxable deficit, in respect of the corporation resident in Canada, at that time (or, if there is no such excess, nil),

  - the particular foreign affiliate's taxable deficit in respect of the corporation resident in Canada, immediately before the dividend time, is deemed to be the amount, if any, by which the particular foreign affiliate's consolidated taxable deficit exceeds the amount of the particular foreign affiliate's consolidated taxable surplus, in respect of the corporation resident in Canada, at that time (or, if there is no such excess, nil),

  - the particular foreign affiliate's underlying foreign tax in respect of the corporation resident in Canada, immediately before the dividend time, is deemed to be the amount of the particular

foreign affiliate's consolidated underlying foreign tax in respect of the corporation resident in Canada, at that time, and

- the particular foreign affiliate's consolidated net surplus in respect of the corporation resident in Canada, immediately before the dividend time, is deemed to be the amount, if any, by which

  - the total of the particular foreign affiliate's consolidated exempt surplus in respect of the corporation resident in Canada, at that time, and the particular foreign affiliate's consolidated taxable surplus in respect of the corporation resident in Canada, at that time,

  exceeds

  - the total of the particular foreign affiliate's consolidated exempt deficit in respect of the corporation resident in Canada, at that time, and the particular foreign affiliate's consolidated taxable deficit in respect of the corporation resident in Canada, at that time.

- New paragraph (*f*) provides that the amount of the attributed net surplus in respect of a disposed share of the specified class in respect of the particular foreign affiliate's consolidated net surplus in respect of the corporation resident in Canada, immediately before the dividend time, is deemed to be the amount that would be received by the holder of the disposed share, in respect of the disposed share, at the dividend time, if the particular foreign affiliate paid a dividend, at that time, on all of its shares, the total of which was equal to the amount of its consolidated net surplus in respect of the corporation resident in Canada, immediately before the dividend time.

- New paragraph (*g*) provides, for the purposes of applying subsection 5901(1) to subsection 5900(1), that the amount of the whole dividend paid by the particular foreign affiliate, at the dividend time, on the shares of the specified class is deemed to be the amount obtained when the total of all amounts deemed by subsection 93(1) or 93(1.2) of the Act to have been received as a dividend on a disposed share of the specified class is multiplied by the greater of

  - one, and

  - the amount determined by the formula

$$A/B$$

where

A is the amount determined, under subparagraph (*e*)(vi), to be the particular foreign affiliate's consolidated net surplus in respect of the corporation resident in Canada, immediately before the dividend time, and

B is the greater of

- one, and
- the aggregate of all amounts each of which is the amount determined, under paragraph (*f*), to be the amount of the attributed net surplus, in respect of a disposed share of the specified class, in respect of the particular foreign affiliate's consolidated net surplus, in respect of the corporation resident in Canada, immediately before the dividend time.

- New paragraph (*h*) provides that the amount prescribed, for the purposes of subsection 93(1) or (1.2) of the Act, in respect of a disposition of a disposed share of the specified class may not exceed the amount of the attributed net surplus in respect of the disposed share in respect of the particular foreign affiliate's consolidated net surplus (determined under paragraph (*f*)), in respect of the corporation resident in Canada, immediately before the dividend time.
- New paragraph (*i*) provides, for the purposes of paragraphs (*a*) to (*d*), that the consolidated net surplus in respect of a corporation resident in Canada, at any time, of a particular foreign affiliate of the corporation resident in Canada, is the amount that would be determined in paragraph (*e*) in respect of the particular foreign affiliate if the reference in that paragraph to "immediately before the dividend time" were read as a reference to "at any time".

ITR
5902(3)

Subsection 5902(3) provides that, where an election is made under subsection 93(1) of the Act, no adjustment is to made to the foreign affiliate's exempt surplus, exempt deficit, taxable surplus, taxable deficit or underlying foreign tax in respect of the corporation as a consequence of the election except as provided in subsections 5905(2), (5) and (8). The amendment to subsection 5902(3) extends the application of the provision to elections made under new subsection 93(1.2) of the Act, and also includes subsection 5905(4) in the list of provisions that may affect these amounts.

ITR
5902(6)

Subsection 5902(6) of the Regulations applies where subsection 93(1.1) of the Act deems a corporation to have made an election under subsection 93(1) to treat proceeds of disposition of a share of a foreign affiliate as a dividend. Subsection 5902(6) deems the amount designated in the deemed election to be the lesser of the capital gain otherwise determined in respect of the disposition of the share and the amount that could reasonably be expected to have been received on the share if the affiliate had paid its net surplus in respect of the corporation as a dividend.

As announced in 2001, subsection 5902(6) is amended to ensure that the subsection will apply where subsection 93(1.3) of the Act deems a corporation resident in Canada to have made an election under proposed subsection 93(1.2) of the Act in respect of a taxable capital gain from a deemed disposition of a share of a foreign affiliate of the corporation disposed of by a partnership of which another foreign affiliate of the corporation is a member.

Subsection 5902(6) is further amended to refer, in paragraph (*b*), to the amount of the "attributed net surplus" (defined in new paragraph 5902(1)(*f*)) in respect of the share being disposed of.

ITR
5902(7)

New subsection 5902(7) of the Regulations provides that the amount designated in an election deemed by subsection 93(1.3) of the Act to have been made under subsection 93(1.2) of the Act is prescribed to be the lesser of

- the taxable capital gain, if any, otherwise determined in respect of the disposition of the share; and
- the amount that is ½ of the amount referred to in paragraph 5902(6)(*b*).

***Example - Subsection 5902(1)***

***A. Facts***

*1. Canco is a corporation resident in Canada.*

*2. Canco owns 100% of FA1 and 50% of FA6, and both FA1 and FA6 are foreign affiliates of Canco.*

*3. FA1 owns 80 shares (80%) of FA2 and FA6 owns 20 shares (20%) of FA2.*

*4. FA2 owns 70% of FA3, FA3 owns 100% of FA4 and FA4 owns 100% of FA5.*

*5. FA1 transfers 30 of its shares in FA2 to FA6, and subsection 93(1) of the Act applies to the transfer, regarding which Canco designates $123 as the dividend received by FA1 in respect of the disposed shares.*

*6. At the time of the transfer, FA2 has an exempt surplus of $200, a taxable surplus of $0, an exempt deficit of $0 and an underlying foreign tax ("UFT") of $0.*

*7. At the time of the transfer, FA3 has an exempt surplus of $100, a taxable surplus of $75, an exempt deficit of $0 and an UFT of $10.*

*8. At the time of the transfer, FA4 has an exempt surplus of $0, a taxable surplus of $0, an exempt deficit of $200 and an UFT of $0.*

*9. At the time of the transfer, FA5 has an exempt surplus of $0, a taxable surplus of $325, an exempt deficit of $0 and an UFT of $200.*

*10. All the corporations have only issued 100 shares of one class.*

***B. Application of Subsection 5902(1)***

***1. Consolidated Exempt Surplus (Paragraph 5902(1)(a))***

*The consolidated exempt surplus of FA2 is $270.*

***Step 1.*** *Exempt surplus of FA5 is determined as the exempt surplus of FA5 ($0), otherwise determined.*

***Step 2.*** *Exempt surplus of FA4 is determined as the exempt surplus of FA4 ($0), otherwise determined, plus proportionate share of exempt surplus of FA5*

$$\$0 + A/B \times C = \$0$$

*where*

*A is the amount that would be received by FA4 if FA5 paid its entire consolidated net surplus as a dividend ($325)*

*B is the amount of consolidated net surplus of FA5 ($325)*

*C is the exempt surplus of FA5 ($0).*

*Step 3. Exempt surplus of FA3 is determined as the exempt surplus of FA3 ($100), otherwise determined, plus proportionate share of exempt surplus of FA4*

$$\$100 + A/B \times C = \$100$$

*where*

*A is the amount that would be received by FA3 if FA4 paid its entire consolidated net surplus as a dividend ($125)*

*B is the amount of consolidated net surplus of FA4 ($125)*

*C is the exempt surplus of FA4 ($0).*

*Step 4. Exempt surplus of FA2 is determined as the exempt surplus of FA2 ($200), otherwise determined, plus proportionate share of exempt surplus of FA3*

$$\$200 + A/B \times C = \$270$$

*where*

*A is the amount that would be received by FA2 if FA3 paid its entire consolidated net surplus as a dividend ($210)*

*B is the amount of consolidated net surplus of FA3 ($300)*

*C is the exempt surplus of FA3 ($100).*

***2. Consolidated Exempt Deficit (Paragraph 5902(1)(b))***

*The consolidated exempt deficit of FA2 is $140.*

*Step 1 Exempt deficit of FA5 is determined as the exempt deficit of FA5 ($0), otherwise determined.*

*Step 2. Exempt deficit of FA4 is determined as the exempt surplus of FA4 ($200), otherwise determined, plus proportionate share of exempt surplus of FA5*

$$\$200 + A/B \times C = \$200$$

*where*

*A is the amount that would be received by FA4 if FA5 paid its entire consolidated net surplus as a dividend ($325)*

*B is the amount of consolidated net surplus of FA5 ($325)*

*C is the exempt deficit of FA5 ($0).*

*Step 3. Exempt deficit of FA3 is determined as the exempt surplus of FA3 ($0), otherwise determined, plus proportionate share of exempt surplus of FA4*

$$\$0 + A/B \times C = \$200$$

*where*

*A is the amount that would be received by FA3 if FA4 paid its entire consolidated net surplus as a dividend ($125)*

*B is the amount of consolidated net surplus of FA4 ($125)*

*C is the exempt deficit of FA4 ($200).*

*Step 4. Exempt deficit of FA2 is determined as the exempt surplus of FA2 ($0), otherwise determined, plus proportionate share of exempt surplus of FA3*

$$\$0 + A/B \times C = \$140$$

*where*

*A is the amount that would be received by FA2 if FA3 paid its entire consolidated net surplus as a dividend ($210)*

*B is the amount of consolidated net surplus of FA3 ($300)*

*C is the exempt deficit of FA3 ($200).*

***3. Consolidated Taxable Surplus and Underlying Foreign Tax (Paragraph 5902(1)(c))***

*The consolidated taxable surplus of FA2 is $280 and the UFT of FA2 is $147.*

*Step 1. The taxable surplus and UFT of FA5 is determined as the taxable surplus ($320) and UFT ($200), otherwise determined.*

*Step 2. The taxable surplus and UFT of FA4 is determined as the taxable surplus ($0) and UFT ($0), of FA4, otherwise determined, plus the proportionate share of the taxable surplus and UFT of FA5*

$$\$0 + A/B \times C = \text{taxable surplus } (\$320) \text{ and } \$0 + A/B \times C = \text{UFT } (\$200)$$

*where*

*A is the amount that would be received by FA4 if FA5 paid its entire consolidated net surplus as a dividend ($325)*

*B is the amount of consolidated net surplus of FA5 ($325)*

*C is the taxable surplus ($325) and UFT ($200) of FA5.*

***Step 3**. The taxable surplus and UFT of FA3 is determined as the taxable surplus ($75) and UFT ($10), of FA3, otherwise determined, plus proportionate share the taxable surplus and UFT of FA4*

*$75 + A/B x C = taxable surplus ($400) and $10 + A/B x C = UFT ($210)*

*where*

*A is the amount that would be received by FA3 if FA4 paid its entire consolidated net surplus as a dividend ($125)*

*B is the amount of consolidated net surplus of FA4 ($125)*

*C is the taxable surplus ($325) and underlying foreign tax ($200) of FA4.*

***Step 4**. The taxable surplus and UFT of FA2 is determined as the taxable surplus ($0) and UFT ($0), of FA2, otherwise determined, plus the proportionate share of the taxable surplus and UFT of FA3*

*$0 + A/B x C = taxable surplus ($280) and $0 + (A/B) x C = UFT ($147)*

*where*

*A is the amount that would be received by FA2 if FA3 paid its entire consolidated net surplus as a dividend ($210)*

*B is the amount of consolidated net surplus of FA3 ($300)*

*C is the taxable surplus ($400) and underlying foreign tax ($210) of FA3.*

*__4. Consolidated Net Surplus (Paragraph 5902(1)(e))__*

*The consolidated net surplus of FA2 is $410 and is determined as follows:*

$$(A + B) - (C + D) = \$410$$

*where*

*A is the consolidated exempt surplus of FA2 ($270)*

*B is the consolidated taxable surplus of FA2 ($280)*

*C is the consolidated exempt deficit of FA2 ($140)*

*D is the consolidated taxable deficit of FA2 ($0).*

*__5. Attributed Surplus (Paragraph 5902(1)(f))__*

*The attributed net surplus in respect of each of the disposed shares is determined as follows:*

$$A/B = \$\ 4.10$$

*where*

*A is the consolidated net surplus ($410)*

*B is the total number of shares issued by FA3 (100).*

*__6. The Whole Dividend (Paragraph 5902(1)(g))__*

*Assuming that the corporation resident in Canada elected, with respect to each share disposed of, under subsection 93(1) of the Act an amount equal to the attributed net surplus in respect of the share, the amount of the whole dividend paid by the foreign affiliate on the shares of the class would be determined as*

$$(A \times B) \times C = \$410$$

*where*

*A is the amount elected with respect to a disposed share ($4.10)*

*B is the number of shares disposed of (30)*

*C is 410/123 = 3.33.*

**Effective Dates**

The amendments to section 5902 apply in respect of elections made under subsection 93(1) or (1.2) of the *Income Tax Act* in respect of dispositions that occur after December 20, 2002 other than dispositions made under agreements in writing made by the vendor on or before December 20, 2002.

If the taxpayer makes an election under subsection 93(1) or (1.2) of the *Income Tax Act* in respect of a disposition that occurs after December 20, 2002 and before Announcement Date and the taxpayer makes a valid election under subsection 133(40) of the legislative proposals relating to the *Income Tax Act* released contemporaneously with these draft Regulations, the amendments to section 5902 do not apply and section 5902 is to be read as if it contained a subsection (6.1) that read as set out in subparagraph 5(*a*)(ii) of the enacting legislation for these proposed amendments to section 5902.

The amendments to section 5902 of the Regulations do not apply to an election by the taxpayer under subsection 93(1) or (1.2) of the *Income Tax Act* in respect of a disposition that occurs after December 20, 2002 (other than a disposition made under an agreement in writing made by the vendor on or before December 20, 2002) and before Announcement Date if the taxpayer does not elect under subsection 133(40) of the legislative proposals relating to the *Income Tax Act* and none of paragraphs 88(3)(*a*), 95(2)(*c*.2), and (*d*) to (*e*.5) of the *Income Tax Act* applies to the disposition.

The amendments to section 5902 of the Regulations do not apply to an election by the taxpayer under subsection 93(1) or (1.2) of the *Income Tax Act* in respect of a disposition that occurs after Announcement Date if the disposition is made under an agreement in writing made by the vendor on or before Announcement Date and none of paragraphs 88(3)(*a*) and 95(2)(*c*.2), and (*d*) to (*e*.5) of the Act applies to the disposition.

ITR
5905

Section 5905 of the Regulations provides special rules, for the purposes of determining surpluses and deficits and underlying foreign tax balances of a foreign affiliate in respect of a corporation resident in Canada.

The rules in section 5905 are being amended to require adjustments to the surplus balances of a foreign affiliate of a corporation resident in Canada in respect of dividends and consolidations of surplus accounts arising because of elections by the corporation resident in

Canada under subsection 93(1) or (1.2) of the Act in respect of a disposition of a share of a foreign affiliate of the corporation resident in Canada.

ITR
5905(1)

Subsection 5905(1) of the Regulations provides rules for computing the amount of the exempt surplus or exempt deficit, the taxable surplus or taxable deficit and the underlying foreign tax, in respect of the corporation resident in Canada, of a foreign affiliate of the corporation resident in Canada when the surplus entitlement percentage of the corporation resident in Canada in respect of a foreign affiliate of that corporation increases because of the acquisition of shares of a non-resident corporation. Subsection 5905(1) is being repealed and replaced by proposed new subsection 5905(1) that clarifies the operation of the rule.

Proposed new subsection 5905(1) of the Regulations provides that if, at any time, other than in the course of a transaction to which subsection 5905(2) or (5) applies, a corporation resident in Canada or a foreign affiliate of such a corporation acquires shares of the capital stock of another corporation that was, immediately after that time, a foreign affiliate of a corporation resident in Canada (the "acquired affiliate") and as a result of the acquisition the surplus entitlement percentage of the corporation resident in Canada in respect of the acquired affiliate or any other affiliate (the acquired affiliate and each such other affiliate referred to as a "relevant foreign affiliate") increases, the following rules apply.

- The amount of the exempt surplus or exempt deficit, the taxable surplus or taxable deficit and the underlying foreign tax, in respect of the corporation resident in Canada, of the particular relevant foreign affiliate, is to be adjusted to become the proportion of the amount determined without making this adjustment, that

  - the surplus entitlement percentage immediately before that time of the corporation resident in Canada in respect of the particular relevant foreign affiliate determined on the assumption that the taxation year of the particular relevant foreign affiliate that otherwise would have included that time had ended immediately before that time,

  is of

  - the surplus entitlement percentage immediately after that time of the corporation resident in Canada in respect of the particular relevant foreign affiliate determined on the assumption that the

taxation year of the particular relevant foreign affiliate that otherwise would have included that time had ended immediately after that time.

- For the purposes of applying the definitions "exempt deficit", "exempt surplus", "taxable deficit", "taxable surplus" and "underlying foreign tax", in subsection 5907(1), the adjusted amounts determined above are deemed to be, in respect of the particular relevant foreign affiliate, the opening exempt deficit, opening exempt surplus, opening taxable deficit, opening taxable surplus and opening underlying foreign tax, of the particular relevant foreign affiliate in respect of the corporation.

Proposed new subsection 5905(1) of the Regulations applies to acquisitions after Announcement Date.

ITR
5905(2)

Subsection 5905(2) of the Regulations applies where shares of a foreign affiliate of a corporation resident in Canada are redeemed, acquired or cancelled (otherwise than by way of a winding-up). If the corporation has made an election under subsection 93(1) of the Act or if the corporation's surplus entitlement percentage in the affiliate changes, then the affiliate's surplus balances are adjusted to offset the change in the surplus entitlement percentage. Subsection 5905(2) is being repealed and replaced by proposed new subsection 5905(2) which adjusts surplus balances of the foreign affiliate in respect of an election under subsection 93(1) or (1.2) of the Act.

Proposed new subsection 5905(2) applies in respect of dispositions in respect of which an election was made in respect of which proposed new subsection 5902(1) applies.

Proposed new subsection 5905(2) provides that, if, at any time (in this subsection, the "disposition time") a particular foreign affiliate of the corporation resident in Canada redeems, acquires or cancels (other than a redemption, an acquisition or a cancellation in respect of which an adjustment has previously been made under this subsection or subsection (1) as it read prior to November 13, 1981) in any manner whatever (otherwise than by way of a winding-up) one or more shares (referred to in this subsection and subsections 5902(16) to (23) as "disposed shares") of any class of its capital stock, the following rules apply.

- If, because of an election made by the corporation resident in Canada under subsection 93(1) or (1.2) of the Act in respect of the disposition of the disposed shares, a dividend (in this subsection and subsections 5905(18) and (21), the "disposition dividend") is deemed to have been received on the disposed shares, by the corporation or by another foreign affiliate, for the purposes of the adjustment required by paragraph (*b*) of the subsection,

  - in computing the exempt surplus in respect of the corporation resident in Canada of the particular foreign affiliate or of another foreign affiliate (the particular foreign affiliate and each other foreign affiliate being referred to in this subsection and subsections 5905(16) to (23) as the "particular relevant foreign affiliate") in which the particular foreign affiliate has an equity percentage at the time (in this subsection and subsections 5905(16) to (22), the "balance adjustment time") that is immediately before the disposition time, there is included, under subparagraph (v) of the description of B in the definition "exempt surplus" in subsection 5907(1), the total of

    - the amount of the exempt surplus reduction of the particular relevant foreign affiliate in respect of the disposed shares,

    - the amount of the exempt deficit reduction of the particular relevant foreign affiliate in respect of the disposed shares, and

    - the amount of the taxable deficit allocation of the particular relevant foreign affiliate in respect of the disposed shares,

  - in computing the particular relevant foreign affiliate's taxable surplus in respect of the corporation resident in Canada at the balance adjustment time there is to be included, under subparagraph (v) of the description of B in the definition "taxable surplus" in subsection 5907(1), the total of

    - an amount equal to the taxable surplus reduction of the particular relevant foreign affiliate in respect of the disposed shares,

    - an amount equal to the taxable deficit reduction of the particular relevant foreign affiliate in respect of the disposed shares, and

    - an amount equal to the exempt deficit allocation of the particular relevant foreign affiliate in respect of the disposed shares,

- in computing the particular relevant foreign affiliate's underlying foreign tax, in respect of the corporation resident in Canada, at the balance adjustment time, there is included, under subparagraph (iii) of the description of B in the definition "underlying foreign tax" in subsection 5907(1), the total of

  - the amount determined by the formula

$$A/B \times C \times D$$

    where

    A is the portion of the particular relevant foreign affiliate's underlying foreign tax in respect of the corporation resident in Canada, at the balance adjustment time, that can reasonably be considered to have been included in computing the particular foreign affiliate's consolidated underlying foreign tax (as determined under paragraph 5902(1)(*c*)), in respect of the disposition,

    B is the particular foreign affiliate's consolidated underlying foreign tax in respect of the corporation resident in Canada (as determined under paragraph 5902(1)(*c*)), in respect of the disposition,

    C is the portion of the particular foreign affiliate's consolidated underlying foreign tax in respect of the corporation resident in Canada (as determined under paragraph 5902(1)(*c*)), in respect of the disposition), that is prescribed, by paragraph 5900(1)(*d*), to be applicable to the portion of the whole dividend (as determined, under paragraph 5902(1)(*g*), in respect of the disposition dividend in respect of the disposed shares) paid on shares of the specified class that is prescribed, by paragraph 5900(1)(*c*), to have been paid out of the particular foreign affiliate's consolidated taxable surplus, and

    D is the specified adjustment factor in respect of the particular relevant foreign affiliate,

    - however, if, in respect of the particular relevant foreign affiliate, the value determined for B in the formula is nil, the amount determined by the formula, in respect of the relevant foreign affiliate, is deemed to be nil, and

  - an amount equal to the underlying foreign tax reduction in respect of the corporation resident in Canada, of the particular relevant foreign affiliate of the corporation resident

in Canada, in respect of the disposition of the disposed shares,

- in computing the particular relevant foreign affiliate's exempt deficit, at the balance adjustment time, there is included, under subparagraph (viii) of the description of A in the definition "exempt surplus" in subsection 5907(1), an amount equal to the exempt deficit, in respect of the corporation resident in Canada, of the particular relevant foreign affiliate, immediately before that time, and

- in computing the particular relevant foreign affiliate's taxable deficit, in respect of the corporation resident in Canada, at the balance adjustment time, there is included, under subparagraph (vi) of the description of A in the definition "taxable surplus" in subsection 5907(1), an amount equal to the taxable deficit, in respect of the corporation resident in Canada, of the particular relevant foreign affiliate, immediately before that time.

• The amount, at the balance adjustment time, of exempt surplus, exempt deficit, taxable surplus, taxable deficit and underlying foreign tax in respect of the corporation resident in Canada of the particular relevant foreign affiliate is adjusted to become the proportion of that amount, determined without making this adjustment, that

  - the surplus entitlement percentage, at the balance adjustment time, of the corporation resident in Canada, in respect of the particular relevant foreign affiliate, determined on the assumption that the taxation year, of the particular relevant foreign affiliate, that otherwise would have included that time, had ended immediately before that time,

  is of

  - the surplus entitlement percentage, immediately after the time of the disposition, of the corporation resident in Canada, in respect of the particular relevant foreign affiliate, determined assuming that the taxation year of the particular relevant foreign affiliate, that otherwise would have included the balance adjustment time, had ended at the time of the disposition.

• For the purposes of applying the definitions "exempt deficit", "exempt surplus", "taxable deficit", "taxable surplus" and "underlying foreign tax", in subsection 5907(1), the amounts determined under paragraph 5905(2)(*b*), in respect of the particular relevant foreign affiliate, are deemed to be the opening exempt deficit, opening exempt surplus, opening taxable deficit, opening

taxable surplus and opening underlying foreign tax, in respect of the corporation resident in Canada, of the particular relevant foreign affiliate.

**Example - Subsection 5905(2)**

**Facts**

1. Canco, a corporation resident in Canada, owns 100% of FA1, which owns 100 shares (100%) of FA2.

2. FA2 owns 100% of FA3.

4. Each of FA1, FA2 and FA3 are foreign affiliates of Canco.

5. FA2 redeems 10 (10%) of its shares owned by FA1.

6. Canco elects under subsection 93(1) of the Act at a designated amount of $30.

7. At the time of the redemption, FA2 has exempt surplus of $0, exempt deficit of $150, taxable surplus of $0, taxable deficit of $200 and underlying foreign tax ("UFT") of $0.

8. At the time of the redemption, FA3 has exempt surplus of $500, exempt deficit of $0, taxable surplus of $150, taxable deficit of $0 and UFT of $0.

9. All the corporations have only issued 100 shares of one class.

**Application of subsection 5905(2) to FA3**

Subsection 5905(2) applies to adjust the exempt surplus, exempt deficit, taxable surplus, taxable deficit and UFT of each of FA2 and FA3.

For the calculation of consolidated exempt surplus, consolidated exempt deficit, consolidated taxable surplus, consolidated taxable deficit and consolidated underlying foreign tax, see the example in the commentary to subsection 5902(1) of the Regulations.

## FA3

Since FA3 has only exempt surplus and taxable surplus, it is only those amounts that must be adjusted.

### A. Exempt surplus - FA3

The exempt surplus (otherwise determined) of FA3 is reduced by each of the exempt surplus reduction, exempt deficit reduction and taxable deficit allocation, in respect of the corporation resident in Canada, of FA3 in respect of the disposed shares (see subsections 5905(16) to (22)).

The adjusted amount of the exempt surplus, in respect of the corporation resident in Canada, of FA3 that is determined under paragraph 5905(2)(a) is \$500 - (\$30 + \$150 + \$50) = \$270. No adjustments are required to be made under paragraph 5905(2)(b) because there is no change in the surplus entitlement percentage of the corporation resident in Canada in respect of FA3.

#### 1. Exempt surplus reduction - FA3

The exempt surplus reduction, in respect of the corporation resident in Canada, of FA3 in respect of the disposed shares is determined as follows

$$A/B \times C \times D = \$500 / \$500 \times \$30 \times 1 = \$30$$

where

A is the exempt surplus in respect of the corporation resident in Canada of FA3 that was included in consolidated exempt surplus in respect of the corporation resident in Canada of FA2 determined under subsection 5902(1) (\$500)

B is the consolidated exempt surplus, in respect of the corporation resident in Canada, of FA2 determined under subsection 5902(1) (\$500)

C is the portion of the dividend received on the disposed shares because of the election under subsection 93(1) that is, pursuant to paragraph 5900(1)(a), prescribed to be paid out of the consolidated exempt surplus of FA2 (\$300 / \$300 x \$30 = \$30)

D is the specified adjustment factor (see subsection 5905(23)), in respect of the corporation resident in Canada, in respect of FA3, of FA1 (1).

**2. Exempt deficit reduction - FA3**

The exempt deficit reduction in respect of the corporation resident in Canada of FA3 in respect of the disposed shares is determined as follows

A/B x C/ D = \$500 / \$500 x \$150 / 1 = \$150

where

A is the exempt surplus, in respect of the corporation resident in Canada, of FA2 that was included in the consolidated exempt surplus, in respect of the corporation resident in Canada, of FA2 determined under subsection 5902(1) (\$500)

B is the consolidated exempt surplus, in respect of the corporation resident in Canada, of FA2 determined under subsection 5902(1) (\$500)

C is the consolidated exempt deficit, in respect of the corporation resident in Canada, of FA2 determined under subsection 5902(1) (\$150)

D is the amount that would be the surplus entitlement percentage of FA2 in FA3 if FA2 were the corporation resident in Canada (1).

***3. Taxable deficit allocation - FA3***

*The taxable deficit allocation is determined as follows*

*1/E x (A - B) x C/D*

*1 / 100% x (\$200 - \$150) x (\$500 / \$500) = \$50*

*where*

*A is the amount of the consolidated taxable deficit, in respect of the corporation resident in Canada, of FA2 (determined under subsection 5902(1)) in respect of the disposition of the disposed shares (\$200)*

*B is the amount of the consolidated taxable surplus, in respect of the corporation resident in Canada, of FA2 (determined under subsection 5902(1)) in respect of the disposition of the disposed shares (\$150)*

*C is the exempt surplus, in respect of the corporation resident in Canada, of FA3 that was included in consolidated exempt surplus, in respect of the corporation resident in Canada, of FA2 determined under subsection 5902(1) (\$500)*

*D is the consolidated exempt surplus, in respect of the corporation resident in Canada, of FA2 determined under subsection 5902(1) ($500)*

*E is the amount that would be the surplus entitlement percentage of FA2 in FA3 if FA2 were the corporation resident in Canada (100%).*

***B. Taxable surplus - FA3***

*In this example, taxable surplus is only reduced by the taxable deficit reduction.*

*The adjusted amount of taxable surplus in respect of the corporation resident in Canada of FA3 that is determined under paragraph 5905(2)(a) is $150 - $150 = $0. No adjustments are required to be made under paragraph 5905(2)(b) because there is no change in the surplus entitlement percentage of the corporation resident in Canada in respect of FA3.*

***1. Taxable deficit reduction - FA3***

*The taxable deficit reduction is determined as $150 since the consolidated taxable deficit of FA2 exceeds the consolidated taxable surplus of FA2 in respect of the disposition of the FA2 shares (see paragraph (b) of the definition "taxable deficit reduction" in subsection 5905(20).*

*Note that with respect to FA2, the amounts that have to be adjusted are its taxable deficit and exempt deficit, which are both reduced to $0. As all accounts of FA2 are $0, no paragraph 5905(2)(b) adjustment is necessary.*

ITR
5905(4)

Subsection 5905(4) of the Regulations provides rules for the operation of subsection 5905(3), concerning foreign mergers.

Subsection 5905(4) is replaced by new subsection 5905(4) and adjusts surplus accounts in respect of a corporation resident in Canada of a foreign affiliate of the corporation resident in Canada in respect of elections made by the corporation resident in Canada under subsections 93(1) and (1.2) of the Act in respect of shares of the foreign affiliate that are disposed of.

Proposed new subsection 5905(4) applies in respect of dispositions in respect of which an election was made in respect of which proposed new subsection 5902(1) applies.

Proposed new subsection 5905(4) provides, for the purposes of subsection 5905(3), the following rules:

- if, at any time, a foreign affiliate of a corporation resident in Canada disposes of one or more shares (in this subsection and subsections 5905(16) to (23), the "disposed shares") of a class of the capital stock of a predecessor corporation and the foreign affiliate of the corporation resident in Canada is, because of an election made under subsection 93(1) or (1.2) of the Act, deemed to have received a dividend (in this subsection and subsections (18) and (21), the "disposition dividend") on the disposed shares, for the purposes of the adjustments required by paragraphs (*b*) and 5905(3)(*b*),

  - in computing the exempt surplus in respect of the corporation resident in Canada of each predecessor corporation and each other foreign affiliate of the corporation resident in Canada in which a predecessor foreign affiliate has an equity percentage (the particular predecessor corporation and each such other foreign affiliate being referred to in this subsection and subsections 5905(16) to (23) as the "particular relevant foreign affiliate") at the time (referred to in this subsection and subsections 5905(16) to (22) as the "balance adjustment time") that is immediately before the foreign merger, there is to be included under subparagraph (v) of the description of B in the definition "exempt surplus" in subsection 5907(1), the total of

    - an amount equal to the exempt surplus reduction in respect of the corporation resident in Canada of the particular relevant foreign affiliate in respect of the disposed shares,

    - an amount equal to the exempt deficit reduction in respect of the corporation resident in Canada of the particular relevant foreign affiliate in respect of the disposed shares, and

    - an amount equal to the taxable deficit allocation in respect of the corporation resident in Canada of the particular relevant foreign affiliate in respect of the disposed shares,

  - in computing the particular relevant foreign affiliate's taxable surplus in respect of the corporation resident in Canada, at the balance adjustment time, there is included, under subparagraph (v) of the description of B in the definition "taxable surplus" in subsection 5907(1), the total of

- the taxable surplus reduction in respect of the corporation resident in Canada of the particular relevant foreign affiliate, in respect of the disposed shares,

- the taxable deficit reduction in respect of the corporation resident in Canada of the particular relevant foreign affiliate, in respect of the disposed shares, and

- the exempt deficit allocation in respect of the corporation resident in Canada of the particular relevant foreign affiliate, in respect of the disposed shares,

\- in computing the particular relevant foreign affiliate's underlying foreign tax at the balance adjustment time, there is included, under subparagraph (iii) of the description of B in the definition "underlying foreign tax" in subsection 5907(1), the total of

- the amount determined by the formula

$$A/B \times C \times D$$

where

A is that portion of the amount of the particular relevant foreign affiliate's underlying foreign tax in respect of the corporation resident in Canada, at the balance adjustment time, that can reasonably be considered to have been included in computing the amount of the consolidated underlying foreign tax (as determined under paragraph 5902(1)(*c*)), of the particular predecessor corporation that issued the disposed shares, in respect of the disposition,

B is the amount of the consolidated underlying foreign tax in respect of the corporation resident in Canada (as determined under paragraph 5902(1)(*c*)), of the particular predecessor corporation that issued the disposed shares, in respect of the disposition,

C is the total of all the amounts determined by paragraph 5900(1)(*d*), to be the amount of foreign tax in respect of the corporation resident in Canada applicable to the portion of the disposition dividend prescribed to have been paid out of the taxable surplus of the issuing foreign affiliate, that relates to a disposed share, in respect of the disposition, and

D is the specified adjustment factor, in respect of the corporation resident in Canada, in respect of the particular relevant foreign affiliate, of the foreign affiliate that disposed of the disposed shares, in respect of the disposition of the disposed shares,

- however, if the amount determined, in respect of the particular relevant foreign affiliate, for B in the formula is nil, the amount determined, in respect of the particular relevant foreign affiliate, by the formula is deemed to be nil,

• an amount equal to the underlying foreign tax reduction in respect of the corporation resident in Canada, of the particular relevant foreign affiliate of the corporation resident in Canada, in respect of the disposition of the disposed shares,

- in computing the exempt deficit in respect of the corporation resident in Canada of the particular relevant foreign affiliate, at the balance adjustment time, there is included, under subparagraph (viii) of the description of A in the definition "exempt surplus" in subsection 5907(1), an amount equal to the exempt deficit, immediately before that time, of the particular relevant foreign affiliate, and

- in computing the particular relevant foreign affiliate's taxable deficit in respect of the corporation resident in Canada, at the balance adjustment time, there is included, under subparagraph (vi) of the description of A in the definition "taxable surplus" in subsection 5907(1), an amount equal to the taxable deficit, immediately before that time, of the particular relevant foreign affiliate.

• The amount, at the balance adjustment time, of exempt surplus, exempt deficit, taxable surplus, taxable deficit and underlying foreign tax, of the particular relevant foreign affiliate is adjusted to become the proportion of that amount, determined without making this adjustment, that

- the surplus entitlement percentage, at the balance adjustment time, of the corporation resident in Canada, in respect of the particular relevant foreign affiliate, determined on the assumption that the taxation year of the particular relevant foreign affiliate, that otherwise would have included that time, had ended immediately before that time,

is of

- the surplus entitlement percentage, immediately after the time of the disposition, of the corporation resident in Canada, in respect of the particular relevant foreign affiliate determined on the assumption that the taxation year, of the particular relevant foreign affiliate, that otherwise would have included the balance adjustment time, had ended at the time of the disposition.

ITR
5905(5), (5.1), (5.2) and (6)

Subsections 5905(5) and (6) of the Regulations apply where, as a result of specified types of transactions, all or any of the shares, of the capital stock of a particular foreign affiliate of a corporation resident in Canada, owned by a "predecessor corporation" are acquired by, or otherwise become the property of, an "acquiring corporation". These transactions are described in detail in paragraphs 5905(5)(*a*), (*b*) and (*c*) and can be generally described as follows:

- a transfer of shares of the capital stock of the particular affiliate by a corporation (the "predecessor corporation") resident in Canada to a taxable corporation resident in Canada (the "acquiring corporation") with which the predecessor corporation does not deal at arm's length;

- an amalgamation of two or more corporations (each corporation being referred to as a "predecessor corporation") to form a new corporation (the "acquiring corporation") if

  - section 87 of the Act applies to the amalgamation, and

  - as a result of the amalgamation, shares of the capital stock of the particular affiliate become the property of the acquiring corporation; or

- a winding-up of a corporation (the "predecessor corporation") into another corporation (the "acquiring corporation") if

  - subsection 88(1) of the Act applies to the winding-up, and

  - as a result of the winding-up, shares of the capital stock of the particular affiliate become the property of the acquiring corporation.

Subsections 5905(5) and (6) provide rules for computing the "opening exempt surplus", "opening exempt deficit", "opening taxable surplus", "opening taxable deficit" and "opening underlying foreign tax" of the

particular affiliate (and of each other foreign affiliate of the predecessor corporation in which the particular affiliate has an equity percentage) in respect of the acquiring corporation. These rules ensure that the appropriate amounts of surplus, deficit and underlying foreign tax balances of the particular affiliate (and of the relevant subsidiaries of the particular affiliate) in respect of the predecessor corporation are assumed by the acquiring corporation as a result of the reorganization.

Subsection 5905(5) (i.e., the portion between paragraph (*c*) and (*d*)) is amended to define the term "particular relevant foreign affiliate" as a particular foreign affiliate and each other foreign affiliate of the predecessor corporation in which the particular affiliate has an equity percentage for the purposes of the subsection and subsections 5905(16) to (23). This amendment applies in respect of dispositions in respect of which an election was made in respect of which proposed new subsection 5902(1) applies.

New subsection 5905(5.1) of the Regulations concerns vertical amalgamations of corporations resident in Canada in respect of which an amount has been designated under paragraph 88(1)(*d*) of the Act in respect of a share of a foreign affiliate of the parent corporation resident in Canada. This new subsection applies in respect of dispositions in respect of which an election was made in respect of which proposed new subsection 5902(1) applies.

Proposed new subsection 5905(5.1) provides that, where there has been an amalgamation described in paragraph 5905(5)(*b*) to which subsection 87(11) of the Act applies and, in respect of that amalgamation, an amount has been - under paragraph 88(1)(*d*) of the Act by the corporation (the "parent corporation") described in subsection 87(11) of the Act as the parent - designated in respect of shares of a corporation (the "particular foreign affiliate") that is, immediately before the amalgamation, a foreign affiliate of the corporation (the "subsidiary corporation") resident in Canada that is described in subsection 87(11) of the Act as the subsidiary, or designated in respect of an interest in a partnership that holds such shares, certain rules apply for the purposes of paragraphs 5905(5)(*d*) to (*h*).

- Subject to paragraph 5905(5.1)(*c*), the amount of the exempt surplus or exempt deficit, taxable surplus or taxable deficit and underlying foreign tax, as the case may be, of the particular foreign affiliate, in respect of the subsidiary corporation and the parent corporation is deemed to be nil, immediately before the amalgamation.

- Subject to paragraph 5905(5.1)(*c*), the amount of the exempt surplus or exempt deficit, taxable surplus or taxable deficit and underlying foreign tax, as the case may be, in respect of the subsidiary corporation, of each other foreign affiliate (a "lower-tier foreign affiliate") of the subsidiary corporation (other than the particular foreign affiliate) in which the particular foreign affiliate has, immediately before the amalgamation, an equity percentage, is deemed to be nil, immediately before the amalgamation.

- Proposed new paragraph 5905(5.1)(*c*) provides that the amount of the exempt surplus or exempt deficit, taxable surplus or taxable deficit and underlying foreign tax, as the case may be, of the particular foreign affiliate and each lower-tier foreign affiliate, in respect of the parent corporation, is deemed to be the amount that would have been determined, if

  - in addition to the shares or partnership interests held by the parent corporation, if any, that are relevant in computing the exempt surplus or exempt deficit, taxable surplus or taxable deficit, and underlying foreign tax, of any foreign affiliate of the parent corporation, in respect of the parent corporation, the shares or partnership interests that were held by the subsidiary corporation at any time in the period (the "control period") that begins at the time the parent corporation last acquired control of the subsidiary corporation and ends immediately before the amalgamation, that are relevant in computing the exempt surplus or exempt deficit, taxable surplus or taxable deficit, and underlying foreign tax, of any foreign affiliate of the subsidiary corporation, in respect of the subsidiary corporation, were held by the parent corporation at the same time in the control period that they were held by the subsidiary corporation,

  - the parent corporation acquired, at the time the parent corporation last acquired control of the subsidiary corporation, all the shares and partnership interests held, at that time, by the subsidiary corporation that are relevant in computing the exempt surplus or exempt deficit, taxable surplus or taxable deficit, and underlying foreign tax, of any foreign affiliate of the subsidiary corporation, in respect of the subsidiary corporation, and

  - where the subsidiary corporation acquired or disposed of any shares or partnership interests in the control period that are relevant in computing the exempt surplus or exempt deficit, taxable surplus or taxable deficit, and underlying foreign tax, of any foreign affiliate of the subsidiary corporation, in respect of the subsidiary corporation, the parent corporation is deemed to have acquired or disposed of, as the case may be, the shares or

partnership interests at the same time they were acquired or disposed of, as the case may be, by the subsidiary corporation.

New subsection 5905(5.2) of the Regulations concerns vertical amalgamations of corporations resident in Canada in respect of which an amount has been designated under paragraph 88(1)(*d*) of the Act in respect of a share of a foreign affiliate of the parent corporation resident in Canada. This new subsection applies in respect of dispositions in respect of which an election was made in respect of which proposed new subsection 5902(1) applies.

New subsection 5905(5.2) provides that, where there has been a winding-up described in paragraph 5905(5)(*c*) and, in respect of that winding-up, an amount has been - under paragraph 88(1)(*d*) of the Act by the corporation (the "parent corporation") described in subsection 88(1) of the Act as the parent - designated in respect of shares of a corporation (the "particular foreign affiliate") that is, immediately before the winding-up, a foreign affiliate of the corporation (the "subsidiary corporation") resident in Canada that is described in subsection 88(1) of the Act as the subsidiary or designated in respect of an interest in a partnership that holds such shares, the following rules apply for the purposes of paragraphs 5905(5)(*d*) to (*h*):

- Subject to paragraph 5905(5.2)(*c*), the amount of the exempt surplus or exempt deficit, taxable surplus or taxable deficit and underlying foreign tax of the particular foreign affiliate, in respect of the subsidiary corporation and the parent corporation is deemed to be nil, immediately before the winding-up.

- Subject to paragraph 5905(5.2)(*c*), the amount of the exempt surplus or exempt deficit, taxable surplus or taxable deficit and underlying foreign tax, as the case may be, in respect of the subsidiary corporation, of each other foreign affiliate (a "lower-tier foreign affiliate") of the subsidiary corporation (other than the particular foreign affiliate) in which the particular foreign affiliate has, immediately before the winding-up, an equity percentage, is deemed to be nil, immediately before the winding-up.

- New paragraph 5905(5.2)(*c*) provides that the amount of the exempt surplus or exempt deficit, taxable surplus or taxable deficit and underlying foreign tax of the particular foreign affiliate and each lower-tier foreign affiliate, in respect of the parent corporation, is deemed to be the amount that would have been determined, if

- in addition to the shares or partnership interests held by the parent corporation, if any, that are relevant in computing the exempt surplus or exempt deficit, taxable surplus or taxable deficit, and underlying foreign tax, of any foreign affiliate of the parent corporation, in respect of the parent corporation, the shares or partnership interests that were held by the subsidiary corporation at any time in the period (the "control period") that begins at the time the parent corporation last acquired control of the subsidiary corporation and ends immediately before the winding-up, that are relevant in computing the exempt surplus or exempt deficit, taxable surplus or taxable deficit, and underlying foreign tax, of any foreign affiliate of the subsidiary corporation, in respect of the subsidiary corporation, were held by the parent corporation at the same time in the control period that they were held by the subsidiary corporation,

- the parent corporation acquired, at the time the parent corporation last acquired control of the subsidiary corporation, all the shares and partnership interests held, at that time, by the subsidiary corporation that are relevant in computing the exempt surplus or exempt deficit, taxable surplus or taxable deficit, and underlying foreign tax, of any foreign affiliate of the subsidiary corporation, in respect of the subsidiary corporation, and

- where the subsidiary corporation acquired or disposed of any shares or partnership interests in the control period that are relevant in computing the exempt surplus or exempt deficit, taxable surplus or taxable deficit, and underlying foreign tax, of any foreign affiliate of the subsidiary corporation, in respect of the subsidiary corporation, the parent corporation shall be deemed to have acquired or disposed of the shares or partnership interests at the same time they were acquired or disposed of by the subsidiary corporation.

Subsection 5905(6) of the Regulations applies when there has been a non-arm's length disposition of shares of a foreign affiliate of a corporation resident in Canada to another corporation resident in Canada. Subsection 5905(6) is being replaced with proposed subsection 5905(6) that requires adjustments of surplus accounts of the foreign affiliate in respect of elections, under subsection 93(1) of the Act, made by the corporation resident in Canada with respect to the disposition of shares of a foreign affiliate of the corporation.

Proposed new subsection 5905(6) provides that, for the purpose of subsection 5905(5), certain rules apply.

- Where paragraph 5905(5)(*a*) applies and the predecessor corporation referred to in that paragraph is, because of an election

made under subsection 93(1) or (1.2) of the Act, deemed to have received a dividend (in this subsection and subsections 5905(18) and (21), the "disposition dividend") on one or more of the shares (each of which is referred to in this subsection and in subsections 5905(16) to (23) as a "disposed share") of the particular foreign affiliate (the "issuing foreign affiliate") disposed of, at that time, in the transaction for the purposes of the adjustment required by paragraph 5905(6)(*b*),

- in computing the exempt surplus, in respect of the predecessor corporation, of a particular relevant foreign affiliate at the time (in this subsection and subsections 5905(16) to (22), the "balance adjustment time") that is immediately before the disposition time, the following rules apply:

  - if certain conditions set out in clause 5905(6)(*a*)(i)(A) are met, there is included under subparagraph (v) of the description of B in the definition "exempt surplus" in subsection 5907(1), the amount determined by the formula

    $$A/B \times C/D$$

    where

    A is the portion of the particular relevant foreign affiliate's exempt surplus, in respect of the predecessor corporation, at the balance adjustment time, that can reasonably be considered to have been included in computing the amount of the issuing foreign affiliate's consolidated exempt surplus (as determined under paragraph 5902(1)(*a*)), in respect of the predecessor corporation, in respect of the disposition of the disposed shares,

    B is the issuing foreign affiliate's consolidated exempt surplus (as determined under paragraph 5902(1)(*a*)), in respect of the predecessor corporation, in respect of the disposition of the disposed shares,

    C is the portion of the disposition dividend that is, because of an election made under subsection 93(1) or (1.2) of the Act in respect of the disposition of the disposed shares, received on the disposed shares by the person that disposed of those shares, that is prescribed by paragraph 5900(1)(*a*) to have been paid out of the issuing foreign affiliate's exempt surplus, in respect of the predecessor corporation, and

D is the surplus entitlement percentage of the predecessor corporation in respect of the particular relevant foreign affiliate at the balance adjustment time, determined on the assumption that the disposed shares were the only shares owned by the predecessor corporation at that time,

- if the amount determined, in respect of the particular relevant foreign affiliate, for either B or D in the formula is nil, the amount determined, in respect of the particular relevant foreign affiliate, by the formula is deemed to be nil,

- there is included under subparagraph (v) of the description of B in the definition "exempt surplus" in subsection 5907(1), the amount of the particular foreign affiliate's exempt surplus in respect of the corporation resident in Canada if the particular foreign affiliate has an amount of exempt surplus in respect of the corporation resident in Canada and the issuing foreign affiliate's (see subsection 5902(1)) consolidated exempt deficit equals or exceeds its consolidated exempt surplus in respect of the corporation resident in Canada, in respect of the disposition of the shares,

- there is included under subparagraph (v) of the description of B in the definition "exempt surplus" in subsection 5907(1), the relevant foreign affiliate's taxable deficit allocation in respect of the disposed shares,

- in computing the taxable surplus, in respect of a predecessor corporation, of the particular relevant foreign affiliate, at the balance adjustment time, the following rules apply:

  - there is included under subparagraph (v) of the description of B in the definition "taxable surplus" in subsection 5907(1), the amount determined by the formula

$$A/B \times C/D$$

where

A is the portion of the amount of the particular relevant foreign affiliate's taxable surplus, in respect of the predecessor corporation, at the balance adjustment time, that can reasonably be considered to have been included in computing the amount of the issuing foreign affiliate's consolidated taxable surplus (as determined under

paragraph 5902(1)(*c*)), in respect of the predecessor corporation, in respect of the disposition of the disposed shares,

B is the amount of the issuing foreign affiliate's consolidated taxable surplus (as determined under paragraph 5902(1)(*c*)), in respect of the predecessor corporation, in respect of the disposition of the disposed shares,

C is the portion, of the disposition dividend that is, because of an election made under subsection 93(1) or (1.2) of the Act in respect of the disposition of the disposed shares, received on the disposed shares by the person that disposed of those shares, that is prescribed by paragraph 5900(1)(*b*) to have been paid out of the issuing foreign affiliate's taxable surplus, in respect of the predecessor corporation, and

D is the surplus entitlement percentage of the predecessor corporation in respect of the relevant foreign affiliate at the balance adjustment time, determined on the assumption that the disposed shares were the only shares owned by the predecessor corporation at that time,

- if the amount determined, in respect of the particular relevant foreign affiliate for either B or D in the formula is nil, the amount determined, in respect of the particular relevant foreign affiliate, by the formula is deemed to be nil,

- there is included under subparagraph (v) of the description of B in the definition "taxable surplus" in subsection 5907(1), the amount of the particular foreign affiliate's taxable surplus in respect of the corporation resident in Canada if the particular foreign affiliate has an amount of taxable surplus in respect of the corporation resident and the issuing corporation's (see subsection 5902(1)) consolidated taxable deficit equals or exceeds its consolidated taxable surplus in respect of the corporation resident in Canada in respect of the disposition of the shares,

- there is included in subparagraph (v) of the description of B in the definition "taxable surplus" in subsection 5907(1), an amount equal to the particular relevant foreign affiliate's exempt deficit allocation in respect of the disposed shares,

- in computing the underlying foreign tax, in respect of the predecessor corporation, of the particular relevant foreign affiliate, at the balance adjustment time, the following rules apply:

  - there is included under subparagraph (iii) of the description of B in the definition "underlying foreign tax" in subsection 5907(1), an amount determined by the formula

$$A/B \times C/D$$

    where

    A is the portion of the amount of the particular relevant foreign affiliate's underlying foreign tax, in respect of the predecessor corporation, at the balance adjustment time, that can reasonably be considered to have been included in computing the amount of the issuing foreign affiliate's consolidated underlying foreign tax (as determined under paragraph 5902(1)(*c*)), in respect of the predecessor corporation, in respect of the disposition,

    B is the amount of the particular relevant foreign affiliate's consolidated underlying foreign tax (as determined under paragraph 5902(1)(*c*)), in respect of the predecessor corporation, in respect of the disposition,

    C is the total of all amounts each of which is the amount, determined by paragraph 5900(1)(*d*), to be the amount of foreign tax applicable to the portion of the disposition dividend prescribed to have been paid out of the taxable surplus of the issuing foreign affiliate, that relates to a disposed share, in respect of the disposition, and

    D is the surplus entitlement percentage of the predecessor corporation in respect of the relevant foreign affiliate at the balance adjustment time, determined on the assumption that the disposed shares were the only shares owned by the predecessor corporation at that time,

  - if the amount determined above, in respect of the particular relevant foreign affiliate, for either B or D in the formula is nil, the amount determined, in respect of the particular relevant foreign affiliate by the formula is deemed to be nil,

  - there is to be included under subparagraph (iii) of the description of B in the definition "underlying foreign tax" in subsection 5907(1), an amount determined by the formula

$$A \times (B + C)/D$$

where

A is the underlying foreign tax in respect of the predecessor corporation of the particular relevant foreign affiliate, at the balance adjustment time,

B is the amount determined under clause 5905(6)(*a*)(ii)(C) in respect of the particular relevant foreign affiliate, in respect of the corporation resident in Canada, in respect of the disposition of disposed shares,

C is the exempt deficit allocation, in respect of the predecessor corporation, of the particular relevant foreign affiliate, in respect of the disposition of the disposed shares, and

D is the taxable surplus in respect of the predecessor corporation of the particular relevant foreign affiliate, at the balance adjustment time,

- in computing the exempt deficit, in respect of the predecessor corporation, of the particular relevant foreign affiliate, at the balance adjustment time, there is included under subparagraph (viii) of the description of A in the definition "exempt surplus" in subsection 5907(1), an amount equal to the exempt deficit, in respect of the predecessor corporation, of the particular relevant foreign affiliate, immediately before that time, and

- in computing the taxable deficit, in respect of the predecessor corporation, of the particular relevant foreign affiliate, at the balance adjustment time, there shall be included under subparagraph (vi) of the description of A in the definition "taxable surplus" in subsection 5907(1), an amount equal to the taxable deficit, in respect of the predecessor corporation, of the particular relevant foreign affiliate, immediately before that time.

• New paragraph 5905(6)(*b*) provides that the exempt surplus or the exempt deficit, the taxable surplus or the taxable deficit and the underlying foreign tax in respect of a predecessor corporation (within the meaning assigned by subsection 5905(5)) and in respect of the acquiring corporation (within the meaning assigned by subsection 5905 (5)) of a particular relevant foreign affiliate is, at the balance adjustment time, to be adjusted to the proportion of the

amount of the surplus, deficit or underlying foreign tax determined without reference to this paragraph that

- the surplus entitlement percentage at the balance adjustment time of the corporation immediately before the time of the latest of the transactions referred to in paragraphs 5905(5)(*a*), (*b*) and (*c*) of the predecessor corporation or the acquiring corporation, as the case may be, in respect of the relevant foreign affiliate, determined on the assumptions

    - that the taxation year of the relevant foreign affiliate that otherwise would have included the balance adjustment time had ended immediately before that time, and

    - where the transaction is a disposition referred to in paragraph 5905(5)(*a*), that the shares referred to therein were the only shares owned by the predecessor corporation at the balance adjustment time,

is of

- the surplus entitlement percentage immediately after the time of the latest of the transactions referred to in paragraphs 5905(5)(*a*), (*b*) and (*c*) of the acquiring corporation in respect of the relevant foreign affiliate, determined on the assumption that the taxation year of the affiliate that otherwise would have included that time had ended immediately after that time.

***Example - Subsection 5905(6)***

***Facts***

*1. Canco, a corporation resident in Canada, owns 100% of Cansub, another corporation resident in Canada.*

*2. Canco owns 90% of FA1.*

*3. Cansub owns 10% of FA1.*

*4. FA1 owns 100% of FA2.*

*5. Both FA1 and FA2 are foreign affiliates of Canco and Subco.*

*6. Canco transfers 10% of the shares of FA1 to Cansub under section 85(1) of the Act, electing under section 93(1) of the Act at a designated amount of $10 in respect of the disposed shares.*

*7. At the time of the transfer, FA1 has exempt surplus of \$0, exempt deficit of \$400, taxable surplus of \$0, taxable deficit of \$0 and underlying foreign tax ("UFT") of \$0.*

*8. At the time of the transfer, FA2 has exempt surplus of \$0, exempt deficit of \$0, taxable surplus of \$500, taxable deficit of \$0 and UFT of \$300.*

*9. All the corporations have only issued 100 shares of one class.*

***Application of paragraph 5905(6)(a)***

*Paragraph 5905(6)(a) of the Regulations applies to adjust the exempt surplus, exempt deficit, taxable surplus, taxable deficit and UFT of each of FA2 and FA3.*

*For an illustration of the calculation of consolidated exempt surplus, consolidated exempt deficit, consolidated taxable surplus, consolidated taxable deficit and consolidated UFT, see the example in the commentary to subsection 5902(1) of the Regulations.*

*This example focuses on FA2.*

***Application of paragraph 5905(6)(a) to FA2***

*FA2 has amounts of taxable surplus and UFT and those amounts must be adjusted.*

*The taxable surplus, in respect of Canco, of FA2 is \$500 - \$100 - \$400 = \$0.*

*The UFT, in respect of Canco, of FA2 is \$300-(\$60 + \$240) = \$0.*

***1. Taxable Surplus Reduction - 5905(6)(a)(ii)(A)***

*The taxable surplus reduction is the amount determined by the formula*

*A/B x C/D = \$500 / \$500 x \$10 / 10% = \$100*

*where*

*A is the taxable surplus, in respect of Canco, of FA2 that was included in consolidated taxable surplus, in respect of Canco, of FA1 determined under subsection 5902(1) (\$500)*

*B is the consolidated taxable surplus, in respect Canco, of FA1 determined under subsection 5902(1) (\$500)*

*C is the portion of the subsection 93(1) dividend in respect of the disposition of the disposed shares that is prescribed by paragraph 5900(1)(b) of the regulations to have been paid out of taxable surplus in respect of Canco ($10)*

*D is the surplus entitlement percentage of Canco determined on the assumption that the disposed shares were the only shares owned by Canco (10%).*

***2. Exempt deficit allocation - 5905(6)(a)(ii)(D)***

*The amount of FA2's exempt deficit allocation is determined by the formula*

$$1/E \times \underline{(A-B) \times C/D}$$

$$1 / 100\% \times (\$400 - 0) \times \$500 / \$300 = \$400$$

*where*

*A is the consolidated exempt deficit, in respect of Canco, of FA1 determined under subsection 5902(1) ($400)*

*B is the consolidated exempt surplus, in respect of Canco, of FA1 determined under subsection 5902(1) ($0)*

*C is the taxable surplus, in respect of Canco, of FA2 that was included in consolidated taxable surplus, in respect of Canco, of FA1 determined under subsection 5902(1) ($500)*

*D is the consolidated taxable surplus in respect of Canco of FA1 determined under subsection 5902(1) ($500)*

*E is the surplus entitlement percentage of FA1 in FA2 (100%).*

***UFT- FA2***

***1. UFT Reduction -5905(6)(a)(iii)(A)***

*The UFT is to be reduced by the amount determined by the formula*

$$A/B \times C/D = \$300 / \$300 \times \$6 / 10\% = \$60$$

*where*

*A is the UFT, in respect of Canco, of FA2 that was included in consolidated UFT, in respect of Canco, of FA1 determined under subsection 5902(1) ($300)*

*B is the consolidated UFT, in respect of Canco, of FA1 determined under subsection 5902(1) ($300)*

*C is the amount prescribed by paragraph 5900(1)(d) to be the UFT, in respect of Canco, applicable to the subsection 93(1) dividend on the disposed shares paid out of the taxable surplus of FA1 ($6)*

*D is the surplus entitlement percentage of Canco in FA2 on the assumption that only the disposed shares were owned by Canco (10%).*

**2. UFT Reduction -5905(6)(a)(iii)(C) and (D)**

*The UFT is to be reduced by the amount determined by the formula*

A x B + C/D = $300 x $ 400/$500 = $240

*where*

*A is the UFT, in respect of Canco, of FA2 that was included in consolidated UFT, in respect of Canco, of FA1 determined under subsection 5902(1) ($300)*

*B is the amount determined under clause 5905(6)(a)(ii)(C) in respect of FA2 in respect of the disposition of the disposed shares ($0)*

*C is the exempt deficit allocation of FA2 in respect of the disposed shares ($400)*

*D is the amount of taxable surplus of FA2 that was included in computing the consolidated UFT, in respect of Canco, of FA1 determined under subsection 5902(1) ($500).*

ITR
5905(7) to (7.4)

Subsection 5905(7) of the Regulations applies where a foreign affiliate (the "disposing foreign affiliate") of a corporation resident in Canada dissolves in circumstances where paragraph 95(2)(*e*.1) of the Act applies in respect of the dissolution.

Paragraph 95(2)(*e*.1) of the Act provides for the rollover of capital property, of a disposing foreign affiliate, to another foreign affiliate of the corporation resident in Canada on a liquidation and a dissolution of the disposing foreign affiliate where certain conditions have been met. One of the conditions is that, immediately before the liquidation, the corporation resident in Canada's surplus entitlement percentage in respect of the disposing foreign affiliate was not less

than 90%. Another is that the liquidation is not taxable in the country where the disposing foreign affiliate resides.

Subsection 5905(7) provides that each other foreign affiliate of the corporation resident in Canada that has a direct equity percentage in the disposing foreign affiliate immediately before the time of the dissolution is, for the purposes of computing its exempt surplus, taxable surplus, exempt deficit, taxable deficit and underlying foreign tax balances in respect of the corporation, deemed to have received, immediately before that time, dividends from the disposing affiliate of the amount that that other affiliate could reasonably be expected to have received if the disposing foreign affiliate had paid dividends equal to the amount of its net surplus in respect of the corporation immediately before that time.

Subsection 5905(7) is to be amended in the following ways.

First, it is proposed that subsection 5905(7) be amended to include liquidations and dissolutions to which paragraph 95(2)(*e*) of the Act apply, in addition to liquidations and dissolutions subject to paragraph 95(2)(*e*.1). This amendment applies for all portions of the amended subsection, save for the deeming of the dividend, which is not necessary in the case of a foreign affiliate holding shares in a liquidating or dissolving affiliate to which paragraph 95(2)(*e*) does not apply.

Second, the conditions under which subsection 5905(7) applies are proposed to be amended to refer to a "liquidation and a dissolution" to better track the language in paragraph 95(2)(*e*.1) of the Act.

Third, the subsection is to be amended so that, where paragraph 95(2)(*e*) applies to a liquidation and dissolution, the dividend deemed by that subsection to have been received is considered to have been received immediately before the "specified time". The expression "specified time" is defined in new subsection 5905(7.1) to mean the time that is the earlier of

- time at which the disposing foreign affiliate was dissolved, and
- the time of the earliest distribution of property as part of the liquidation and the dissolution of the disposing foreign affiliate.

Fourth, the subsection is to be amended to deal with the case where the disposing foreign affiliate has an exempt deficit or taxable deficit in respect of the corporation immediately before the specified time. These amendments ensure that, where paragraph 95(2)(*e*) or (*e*.1) applies to the liquidation and dissolution, of the disposing foreign affiliate

- the exempt deficit in respect of the corporation of each other foreign affiliate of the corporation that held a direct equity percentage in the disposing foreign affiliate is, immediately before the specified time, increased by the sum of that other affiliate's proportionate share of the disposing foreign affiliate's exempt deficit in respect of the corporation, immediately before that time, and the amount by which its proportionate share of the exempt deficit of the disposing foreign affiliate immediately before that time exceeds the amount of the decrease (determined under paragraph 5905(7)(*d*)) to the amount of its exempt surplus in respect of the corporation,

- the taxable deficit in respect of the corporation of each other foreign affiliate of the corporation that held a direct equity percentage in the disposing foreign affiliate is, immediately before the specified time, increased by the sum of that other affiliate's proportionate share of the disposing foreign affiliate's taxable deficit in respect of the corporation and the amount by which its proportionate share of the taxable deficit of the disposing foreign affiliate immediately before that time, exceeds the amount of the decrease (determined under paragraph 5905(7)(*e*)) to the amount of its taxable surplus in respect of the corporation,

- the exempt surplus in respect of the corporation of each other foreign affiliate of the corporation that held a direct equity percentage in the disposing foreign affiliate is, immediately before the specified time, decreased by the least of that other affiliate's proportionate share of the disposing foreign affiliate's exempt deficit in respect of the corporation and the amount of its exempt surplus in respect of the corporation, as determined under the definition "exempt surplus" in subsection 5907(1), and

- the taxable surplus in respect of the corporation of each other foreign affiliate of the corporation that held a direct equity percentage in the disposing foreign affiliate is, immediately before the specified time, decreased by the least of that other affiliate's proportionate share of the disposing foreign affiliate's taxable deficit in respect of the corporation and the amount of its taxable surplus in respect of the corporation, as determined under the definition "taxable surplus" in subsection 5907(1).

New subsection 5905(7.1) provides, for the purpose of subsection 5905(5), a definition of the expression "specified time". For more detail, see the commentary to subsection 5905(7) above.

New subsections 5905(7.2) to (7.4) provide for the following rules in relation to section 5905(7):

- For the purposes of subsection 5905(7), the exempt surplus, exempt deficit, taxable surplus, taxable deficit and underlying foreign tax of the disposing foreign affiliate in respect of the corporation at any time is to be determined on the assumption that the taxation year of the disposing foreign affiliate that would otherwise have included that time had ended immediately before that time (subsection 5905(7.2));

- For the purposes of paragraphs 5905(7)(*a*) and (*b*), a foreign affiliate's proportionate share of the exempt deficit, if any, of the disposing foreign affiliate in respect of the corporation at any time is equal to the amount it could reasonably have expected to receive if the disposing foreign affiliate had, immediately before that time, paid a dividend equal to the amount of its exempt deficit, if any, in respect of the corporation (subsection 5905(7.3)); and

- For the purposes of paragraphs 5905(7)(*c*) and (*d*), a foreign affiliate's proportionate share of the taxable deficit, if any, of the disposing foreign affiliate in respect of the corporation at any time is equal to the amount it could reasonably have expected to receive if the disposing foreign affiliate had, immediately before that time, paid a dividend equal to the amount of its taxable deficit, if any, in respect of the corporation (subsection 5905(7.4)).

New subsections 5905(7) to (7.4) ensure that the exempt deficit and the taxable deficit of the disposing foreign affiliate of a group of affiliates in respect of a taxpayer are absorbed by the other foreign affiliates in the group.

New subsections 5905(7) to (7.4) are applicable to dissolutions that occur after December 20, 2002.

ITR
5905(8)

Subsection 5905(8) of the Regulations provides rules for determining surplus balances that apply when a corporation resident in Canada elects under subsection 93(1) or (1.2) of the Act in respect of a disposition of shares of a foreign affiliate (the issuing affiliate) of the corporation to the corporation or to another corporation that was, immediately after the disposition, a foreign affiliate of the corporation and a dividend is, because of the election, deemed to be received. This subsection is replaced with new subsection 5905(8), to provide for adjustments to surplus accounts in respect of the dividends arising because of the elections under subsection 93(1) or (1.2) of the Act.

Proposed new subsection 5905(8) applies if, at any time, a dividend (referred to in this subsection and subsections 5905(18) and (21) as

the "disposition dividend") is, because of an election made by a corporation resident in Canada under subsection 93(1) or (1.2) of the Act, deemed to have been received on disposed shares of a particular foreign affiliate of the corporation resident in Canada that were disposed of to the corporation resident in Canada or another corporation that was, immediately after the disposition, a foreign affiliate of the corporation resident in Canada. It provides the following rules.

- Paragraph 5905(8)(*a*) sets out a number of adjustments, in respect of the corporation resident in Canada, to different surplus accounts, immediately before the disposition of the shares (the "balance adjustment time"), that must be taken into account in determining the adjustment in paragraph 5905(8)(*b*).

    - In computing the exempt surplus, in respect of the corporation resident in Canada, of the issuing foreign affiliate and each other foreign affiliate of the corporation resident in Canada in which the issuing affiliate has an equity percentage (the issuing foreign affiliate and each such other foreign affiliate referred to as the "particular relevant foreign affiliate"), immediately before the disposition (the "balance adjustment time"), there is to be included under subparagraph (v) of the description of B in the definition "exempt surplus" in subsection 5907(1), the aggregate of the exempt surplus reduction, the exempt deficit reduction, and the taxable deficit allocation of that particular relevant foreign affiliate, in respect of the disposed shares. "Exempt deficit reduction", "exempt surplus reduction" and "taxable deficit allocation" are terms defined in subsections 5905(17), (18), and (19), respectively, and are further described in the commentary to those respective subsections.

    - In computing the taxable surplus in respect of the corporation resident in Canada of each particular relevant foreign affiliate, at the balance adjustment time, there is to be included under subparagraph (v) of the description of B in the definition "taxable surplus" in subsection 5907(1), the aggregate of the taxable surplus reduction, the taxable deficit reduction, and the exempt deficit allocation of that particular relevant foreign affiliate, in respect of the disposed shares. "Exempt deficit allocation", "taxable deficit reduction" and "taxable surplus reduction" are terms defined in subsections 5905(16), (20) and (21), respectively.

    - In computing the underlying foreign tax of each particular relevant foreign affiliate there is to be included under subparagraph (iii) of the description of B in the definition "underlying foreign tax" in subsection 5907(1), the total of

- the amount determined by the formula

$$A/B \times C \times D$$

where

A is the portion of the particular relevant foreign affiliate's underlying foreign tax, in respect of the corporation resident in Canada, that can reasonably be considered to have been included in determining the issuing foreign affiliate's consolidated underlying foreign tax (determined in paragraph 5902(1)(*c*)) as a result of the disposition,

B is the issuing foreign affiliate's consolidated underlying foreign tax (determined in paragraph 5902(1)(*c*)) as a result of the disposition,

C is the amount determined under paragraph 5900(1)(*c*) to be the amount of foreign tax applicable to the portion of the disposition dividend prescribed to have been paid out of the taxable surplus of the issuing foreign affiliate that relates to a disposed share, as a result of the disposition,

D is the specified adjustment factor (defined in subsection 5905(23)), in respect of the particular relevant foreign affiliate of the corporation resident in Canada, of the foreign affiliate of the corporation resident in Canada that disposed of the disposed shares, as a result of the disposition of the disposed shares,

- however, where the amount determined by the B in the formula is nil, the amount determined by the formula is determined to be nil, and

- an amount equal to the underlying foreign tax reduction in respect of the corporation resident in Canada, of the particular relevant foreign affiliate of the corporation resident in Canada, in respect of the disposition of the disposed shares.

- In computing the exempt deficit in respect of the corporation resident in Canada at the balance adjustment time of each particular relevant foreign affiliate, there must be added under subparagraph (viii) of the description of A in the definition "exempt surplus" in subsection 5907(1) the amount of the exempt deficit (in respect of the corporation resident in Canada) of that particular relevant foreign affiliate, immediately before the balance adjustment time.

- In computing the taxable deficit in respect of the corporation resident in Canada at the balance adjustment time of each particular relevant foreign affiliate there must be added under subparagraph (vi) of the description of A in the definition "taxable surplus" in subsection 5907(1) the taxable deficit of that particular relevant foreign affiliate, immediately before the balance adjustment time.

• The amount, at the balance adjustment time, of the exempt surplus, exempt deficit, taxable surplus, taxable deficit and underlying foreign tax in respect of the corporation resident in Canada of each particular relevant foreign affiliate is to be adjusted to the proportion of the amount determined, without making this adjustment, that

  - the surplus entitlement percentage, at the balance adjustment time, of the corporation resident in Canada in respect of the particular relevant foreign affiliate, if it were determined on the assumption that the taxation year, of the particular relevant foreign affiliate that otherwise would have included that time, had ended immediately before the balance adjustment time,

  is of

  - the surplus entitlement percentage of the corporation resident in Canada, immediately after the disposition, in respect of the particular relevant foreign affiliate determined on the assumption that the taxation year of the particular relevant foreign affiliate, that otherwise would have included the balance adjustment time, had ended at the time of disposition.

• For the purposes of applying the definitions "exempt deficit", "exempt surplus", "taxable surplus", "taxable deficit" and "underlying foreign tax" in subsection 5907(1), the amounts determined under paragraph 5905(8)(*b*) are deemed to be the opening exempt deficit, opening exempt surplus, opening taxable surplus, opening taxable deficit and opening underlying foreign tax, respectively of the particular relevant foreign affiliate, in respect of the corporation resident in Canada.

Proposed new subsection 5905(8) is applicable to dispositions that occur after December 20, 2002.

***Example* - Subsection 5905(8)**

***Facts***

*1. Canco is a corporation resident in Canada.*

*2. Canco owns 100% of FA1 and 50% of FA6, and both FA1 and FA6 are foreign affiliates of Canco.*

*3. FA1 owns 80 shares (80%) of FA2 and FA6 owns 20 shares (20%) of FA2.*

*4. FA2 owns 70 shares (70%) of FA3, FA3 owns 100% of FA4 and FA4 owns 100% of FA5.*

*5. FA1 transfers 30 of its shares in FA2 to FA6, and subsection 93(1) of the Act applies to the transfer, regarding which Canco designates $123 as the dividend received by FA1 in respect of the disposed shares.*

*6. At the time of the transfer, FA2 has an exempt surplus of $200, a taxable surplus of $0, an exempt deficit of $0 and an underlying foreign tax ("UFT") of $0.*

*7. At the time of the transfer, FA3 has an exempt surplus of $100, a taxable surplus of $75, an exempt deficit of $0 and an UFT of $10.*

*8. At the time of the transfer, FA4 has an exempt surplus of $0, a taxable surplus of $0, an exempt deficit of $200 and an UFT of $0.*

*9. At the time of the transfer, FA5 has an exempt surplus of $0, a taxable surplus of $325, an exempt deficit of $0 and an UFT of $200.*

*10. All the corporations have only issued 100 shares of one class.*

**Application of subsection 5905(8) - FA5**

***I. Paragraph 5905(8)(a) -FA5***

*Paragraph 5905(8)(a) acts to adjust the exempt surplus, exempt deficit, taxable surplus, taxable deficit and UFT in respect of Canco of each of FA2, FA3, FA4 and FA5. This example will focus on FA5.*

***A. Exempt Surplus - FA5***

*First, the adjustment to exempt surplus, in respect of Canco, must be determined by subparagraph 5905(8)(a)(i). However, in this example, FA5 has no exempt surplus, so no calculation is necessary.*

***B. Taxable Surplus - FA5***

*Second, the adjustment to taxable surplus, in respect of Canco, of FA5 must be determined by subparagraph 5905(8)(a)(ii). The taxable*

*surplus of FA5 will be reduced by the total of the taxable surplus reduction, taxable deficit reduction and exempt deficit allocation.*

*The taxable surplus of FA5 is determined as \$325 - \$108.3 = \$216.7.*

*For the calculation of consolidated exempt surplus, consolidated exempt deficit, consolidated taxable surplus, consolidated taxable deficit and consolidated UFT, see the example in the commentary to subsection 5902(1) of the Regulations.*

***1. Taxable surplus reduction - FA5***

*The taxable surplus reduction, in respect of Canco, of FA5 in respect of the disposed shares is the amount determined by the formula:*

$$A/B \times C \times D$$

$$\$227.5 / \$280 \times \$83.99 \times 1.587 = \$108.3$$

*where*

*A is the portion of FA5's taxable surplus, in respect of Canco, that can reasonably be considered to have been included in the consolidated taxable surplus of FA2 (\$325 x .7 = \$227.5)*

*B is the consolidated taxable surplus, in respect of Canco, of FA2 in respect of the disposition of the FA2 shares (\$280)*

*C is the portion of the disposition dividend received by FA1 on the disposed shares, because of the election under section 93(1) of the Act, in respect of the disposition of the disposed shares, that is prescribed by paragraph 5900(1)(b) to have been paid out of the consolidated taxable surplus of FA2 (\$280 / \$410 x \$123 = \$83.99)*

*D is the specified adjustment factor, in respect of Canco, in respect of FA2, of FA1 (100% / 63% = 1.587).*

***2.Taxable deficit reduction- FA5***

*There is no consolidated taxable deficit, in respect of Canco, of FA2. Consequently, there is no taxable deficit reduction, in respect of Canco, in respect of FA5.*

***3. Exempt deficit allocation - FA5***

*There is no consolidated exempt deficit in excess of consolidated exempt surplus, in respect of Canco, of FA2. Consequently, there is no exempt deficit allocation, in respect of Canco, in respect of FA5.*

## *C. Underlying foreign tax - FA5*

*The adjustment to the UFT, in respect of Canco, must be determined by subparagraph 5905(8)(a)(iii). The UFT of FA5 will be reduced by the total of the UFT of FA5 related to any of the taxable surplus reduction, taxable deficit reduction and exempt deficit allocation in respect of Canco of FA5.*

*The underlying foreign tax in respect of Canco of FA5 is determined to be $133.35*
*($200 - $66.65 = 133.35).*

### *1. Underlying foreign tax applicable to subsection 93(1) dividend*

*The reduction of the underlying foreign tax of FA5 related to the taxable surplus reduction is determined by the formula:*

$$A/B \times C \times D = \$140 / \$147 \times \$44.1 \times 1.587 = \$66.65$$

*where*

*A is the portion of the UFT in respect of Canco of FA5 that is included in computing the consolidated UFT in respect of Canco of FA2 ($200 x .7 = $140)*

*B is the consolidated UFT in respect of Canco of FA2 (($200 + $10) x .7 = $147)*

*C is the amount, determined pursuant to paragraph 5900(1)(d), of the consolidated underlying foreign tax applicable to the disposition dividend that relates to disposed shares that is prescribed to have been paid out of taxable surplus ($147 x $84 / $280 = $44.1)*

*D is the specified adjustment factor in respect of Canco in respect of FA5 of FA1 (100% / 63% = 1.587).*

## *D. Exempt deficit reduction*

*The adjustment to the exempt deficit, in respect of Canco, of FA5 would be determined by subparagraph 5905(8)(a)(iv). However, as FA5 has no exempt deficit, no adjustment is necessary.*

## *E. Taxable deficit reduction*

*The adjustment to the taxable deficit, in respect of Canco, of FA5 would be determined by subparagraph 5905(8)(a)(v). However, as FA5 has no taxable deficit, no adjustment is necessary.*

## *II. Paragraph 5905(8)(b) adjustment - FA5*

*Paragraph 5905(8)(b) acts to adjust the exempt surplus, exempt deficit, taxable surplus, taxable deficit and UFT in respect of Canco of each of FA2, FA3, FA4 and FA5. This example will focus on FA5.*

*As FA5 has only taxable surplus and UFT, it is only those accounts that will be adjusted.*

*The taxable surplus and UFT of FA5 is adjusted to be the proportion of the amounts determined above that the surplus entitlement percentage of Canco in respect of FA5, at the balance adjustment time, (determined on the assumption that FA5 had a taxation year ending immediately before that time) is of the surplus entitlement percentage of Canco in respect of FA5, immediately after the disposition, (determined on the assumption that FA5 had a taxation year ending immediately at the time of disposition).*

*Thus, FA5's opening balances after the transaction are as follows:*

- *taxable surplus in respect of Canco is $260.04*
- *UFT in respect of Canco is $160.02*

***A.Taxable surplus***

*$216.7 x 63 / 52.5 = $260.04*

***B. Underlying foreign tax***

*$133.35 x 63 / 52.5 = $160.02*

ITR
5905(16) to (23)

New subsections 5905(16) to (23) of the Regulations define terms used in section 5905. These new subsections apply in respect of dispositions in respect of which an election was made in respect of which proposed new subsection 5902(1) applies.

**"exempt deficit allocation"**

ITR
5905(16)

New subsection 5906(16) of the Regulations defines the expression "exempt deficit allocation", which sets out adjustments to a foreign affiliate's taxable surplus, in respect of the corporation resident in

Canada, in respect of consolidated exempt deficit where consolidated exempt deficit exceeds consolidated exempt surplus, in respect of the corporation resident in Canada, in respect of the disposition of the disposed shares. The subsection adopts, from subsection 5905(8) of the Regulations, the terms "particular relevant foreign affiliate", "balance adjustment time", and "disposed shares".

The exempt deficit allocation in respect of the corporation resident in Canada of the particular relevant foreign affiliate in respect of disposed shares of the foreign affiliate of the corporation resident in Canada that issued the disposed shares (the "issuing foreign affiliate") is, if the particular relevant foreign affiliate has, at the balance adjustment time, an amount of taxable surplus in respect of the corporation resident in Canada and the issuing foreign affiliate has, at that time, an amount of consolidated exempt deficit (as this amount is determined under paragraph 5902(1)(*b*)), in respect of the corporation resident in Canada, as a result of the disposition of the disposed shares, that exceeds the amount of its consolidated exempt surplus (as this amount is determined under paragraph 5902(1)(*a*)), in respect of the corporation resident in Canada, as a result of the disposition of the disposed shares,

- the amount determined by the formula:

$$1/E \times [(A-B) \times C/D]$$

where

A is the amount of the issuing foreign affiliate's consolidated exempt deficit (as this amount is determined under paragraph 5902(1)(*b*)), in respect of the corporation resident in Canada, in respect of the disposition of the disposed shares,

B is the amount of the issuing foreign affiliate's consolidated exempt surplus (as this amount is determined under paragraph 5902(1)(*a*)), in respect of the corporation resident in Canada, in respect of the disposition of the disposed shares,

C is the portion of the amount of the particular relevant foreign affiliate's taxable surplus, in respect of the corporation resident in Canada, immediately before the disposition of the disposed shares, that can reasonably be considered to have been included in computing the amount of the issuing foreign affiliate's consolidated taxable surplus (as this amount is determined under paragraph 5902(1)(*c*)), in respect of the corporation resident in Canada, as a result of the disposition of the disposed shares,

D is the amount, if any, by which the issuing foreign affiliate's consolidated taxable surplus (as this amount is determined under paragraph 5902(1)(*a*)), in respect of the corporation resident in Canada, in respect of the disposition of the disposed shares, and

E is, if the particular relevant foreign affiliate is the issuing foreign affiliate, 1, or, if the particular relevant foreign affiliate is not the issuing foreign affiliate, the surplus entitlement percentage of the issuing foreign affiliate, in respect of the particular relevant foreign affiliate, that, under subsections 5905(10) to (13), would be determined, at the balance adjustment time, if the issuing foreign affiliate were the "corporation resident in Canada" referred to in those subsections and the particular relevant foreign affiliate were the "particular foreign affiliate" referred to in those subsections; and

- if the amount determined, in respect of the particular relevant foreign affiliate, for the description of either D or E in the formula above is nil, the amount determined by the formula is deemed to be nil.

**"exempt deficit reduction"**

ITR
5905(17)

New subsection 5905(17) of the Regulations defines the expression "exempt deficit reduction", which determines the reduction of the exempt surplus of a particular relevant foreign affiliate in respect of the consolidated exempt deficit of the issuing foreign affiliate where the issuing foreign affiliate has consolidated exempt surplus in excess of consolidated exempt deficit, in respect of the corporation resident in Canada. The subsection adopts, from subsection 5905(8) of the Regulations, the terms "particular relevant foreign affiliate", "balance adjustment time", and "disposed shares".

The exempt deficit reduction, in respect of the corporation resident in Canada, of a particular relevant foreign affiliate in respect of disposed shares is

- if the particular relevant foreign affiliate has, at the balance adjustment time, an amount of exempt surplus, in respect of the corporation resident in Canada, and the foreign affiliate of the corporation resident in Canada that issued the disposed shares (the "issuing foreign affiliate") has, at the balance adjustment time, consolidated exempt surplus (as this amount is determined under paragraph 5902(1)(*a*)), in respect of the corporation resident in

Canada, in respect of the disposition of the disposed shares, that exceeds the amount of its consolidated exempt deficit (as this amount is determined under paragraph 5902(1)(*b*)), in respect of the corporation resident in Canada, in respect of the disposition of the disposed shares,

- the amount determined by the following formula

$$A/B \times C/D$$

where

A is the portion of the amount of the particular relevant foreign affiliate's exempt surplus, in respect of the corporation resident in Canada, in respect of the disposition of the disposed shares, at the balance adjustment time, that can reasonably be considered to have been included in computing the amount of the issuing foreign affiliate's consolidated exempt surplus (as that amount is determined under paragraph 5902(1)(*a*)), in respect of the corporation resident in Canada, in respect of the disposition of the disposed shares,

B is the amount of the particular foreign affiliate's consolidated exempt surplus (as determined under paragraph 5902(1)(*a*)), in respect of the corporation resident in Canada, in respect of the disposition of the disposed shares,

C is the amount of the issuing foreign affiliate's consolidated exempt deficit (as this amount is determined under paragraph 5902(1)(*b*)), in respect of the corporation resident in Canada, in respect of the disposition of the disposed shares, and

D is, if the particular relevant foreign affiliate is the issuing foreign affiliate, 1, or, in the case where the particular relevant foreign affiliate is not the issuing foreign affiliate, the surplus entitlement percentage of the issuing foreign affiliate, in respect of the particular relevant foreign affiliate, that, under subsections 5905(10) to (13), would be determined, at the balance adjustment time, if the issuing foreign affiliate were the "corporation resident in Canada" referred to in those subsections and the particular relevant foreign affiliate were the "particular foreign affiliate" referred to in those subsections;

- where the amount determined, in respect of a particular relevant foreign affiliate, for the description of any of A, B or D in the formula is nil, the amount determined by the formula is deemed to be nil; and

- if the particular relevant foreign affiliate has, at the balance adjustment time, an amount of exempt surplus in respect of the corporation resident in Canada and the issuing foreign affiliate has an amount of consolidated exempt deficit (as this amount is determined under paragraph 5902(1)(*b*)), in respect of the corporation resident in Canada, in respect of the disposition of the disposed shares that is equal to or greater than the amount of its consolidated exempt surplus (as this amount is determined under paragraph 5902(1)(*a*)), in respect of the corporation resident in Canada, in respect of the disposition of the disposed shares, the amount of that particular relevant foreign affiliate's exempt surplus.

**"exempt surplus reduction"**

ITR
5905(18)

New subsection 5905(18) of the Regulations defines the expression "exempt surplus reduction", which determines the reduction of the exempt surplus, in respect of the corporation resident in Canada, of a particular relevant foreign affiliate in respect of the disposition dividend of the issuing foreign affiliate where the issuing foreign affiliate has consolidated exempt surplus in excess of consolidated exempt deficit in respect of the corporation resident in Canada. The subsection adopts, from subsection 5905(8) of the Regulations, the terms "particular relevant foreign affiliate", "balance adjustment time", "disposed shares" and "disposition dividend".

The exempt surplus reduction in respect of the corporation resident in Canada of a particular relevant foreign affiliate, in respect of the disposition of the disposed shares is

- the amount determined by the formula

$$A/B \times C \times D$$

where

A is the portion of the amount of the particular relevant foreign affiliate's exempt surplus, in respect of the corporation resident in Canada, at the balance adjustment time, that can reasonably be considered to have been included in computing the amount of the consolidated exempt surplus, in respect of the corporation

resident in Canada, in respect of the disposition of the disposed shares, (as this amount is determined under paragraph 5902(1)(*a*)) of the particular foreign affiliate of the corporation resident in Canada that issued the disposed shares (the "issuing foreign affiliate"),

B is the amount of the issuing foreign affiliate's consolidated exempt surplus (as this amount is determined under paragraph 5902(1)(*a*)), in respect of the corporation resident in Canada, in respect of the disposition of the disposed shares, as a result of the disposition of the disposed shares,

C is the portion of the disposition dividend that, because of an election made under subsection 93(1) or (1.2) of the Act as a result of the disposition of the disposed shares, was received on the disposed shares by the person disposing of them, that is prescribed by paragraph 5900(1)(*a*) to have been paid out of the issuing foreign affiliate's exempt surplus, in respect of the corporation resident in Canada, and

D is the specified adjustment factor (a term also defined in subsection 5905(23)), in respect of the corporation resident in Canada, in respect of the particular relevant foreign affiliate, of the person that disposed of the disposed shares;

- if either A or B of the formula is determined to be nil in respect of the particular foreign affiliate, the amount determined by the formula is deemed to be nil; and

- if an amount is determined respect of the particular relevant foreign affiliate, under paragraph (*b*) of subsection 5905(17) (which subsection defines the expression "exempt deficit reduction"), the amount determined by the formula is deemed to be nil.

**"taxable deficit allocation"**

ITR
5905(19)

New subsection 5905(19) of the Regulations defines the expression "taxable deficit allocation", which determines adjustments to a foreign affiliate's exempt surplus in respect of the corporation resident in Canada, in respect of consolidated taxable deficit, where consolidated taxable deficit exceeds consolidated taxable surplus, in respect of the corporation resident in Canada, in respect of the disposition of the disposed shares. The subsection adopts, from subsection 5905(8) of the Regulations, the terms "particular relevant foreign affiliate", "balance adjustment time", and "disposed shares".

The taxable deficit allocation of a particular relevant foreign affiliate, in respect of disposed shares of the foreign affiliate of the corporation resident in Canada that issued the disposed shares (the "issuing foreign affiliate") is, if the particular relevant foreign affiliate has, at the balance adjustment time, an amount of exempt surplus in respect of the corporation resident in Canada and the issuing foreign affiliate has, at that time, an amount of consolidated taxable deficit (as determined under paragraph 5902(1)(*d*)), in respect of the corporation resident in Canada, in respect of the disposition of the disposed shares, that is equal to or greater than the amount of the issuing foreign affiliate's consolidated taxable surplus (as this amount is determined under paragraph 5902(1)(*c*)), in respect of the corporation resident in Canada, in respect of the disposition of the disposed shares,

- the amount determined by the formula

$$1/E \times (A-B) \times C/D$$

where

A is the amount of the issuing foreign affiliate's consolidated taxable deficit (as this amount is determined under paragraph 5902(1)(*d*)), in respect of the corporation resident in Canada, in respect of the disposition of the disposed shares,

B is the amount of the issuing foreign affiliate's consolidated taxable surplus (as this amount is determined under paragraph 5902(1)(*c*)), in respect of the corporation resident in Canada, in respect of the disposition of the disposed shares,

C is the portion of the amount of the particular relevant foreign affiliate's exempt surplus, in respect of the corporation resident in Canada, immediately before the disposition of the disposed shares, that can reasonably be considered to have been included in computing the amount of the issuing foreign affiliate's consolidated exempt surplus (as this amount is determined under paragraph 5902(1)(*a*)), in respect of the corporation resident in Canada, in respect of the disposition of the disposed shares,

D is the amount of the issuing foreign affiliate's consolidated exempt surplus (as this amount is determined under paragraph 5902(1)(*a*)), in respect of the corporation resident in Canada, in respect of the disposition of the disposed shares, and

E is, if the particular relevant foreign affiliate is the issuing foreign affiliate, equal to 1, and, if the particular relevant

foreign affiliate is not the issuing foreign affiliate, equal to the surplus entitlement percentage of the issuing foreign affiliate, in respect of the particular relevant foreign affiliate, that, under subsections 5905(10) to (13), would be determined, at the balance adjustment time, if the issuing foreign affiliate were the "corporation resident in Canada" referred to in those subsections and the particular relevant foreign affiliate were the "particular foreign affiliate" referred to in those subsections; and

- if the amount determined, in respect of a particular relevant foreign affiliate, for the description of any of D or E in the formula is nil, the amount determined by the formula is deemed to be nil.

**"taxable deficit reduction"**

ITR
5905(20)

New subsection 5905(20) of the Regulations defines the expression taxable deficit reduction, which determines adjustments to a foreign affiliate's taxable surplus, in respect of the corporation resident in Canada, where consolidated taxable surplus exceeds consolidated taxable deficit, in respect of the corporation resident in Canada, in respect of the disposition of the disposed shares. The subsection adopts, from subsection 5905(8) of the Regulations, the terms "particular relevant foreign affiliate", "balance adjustment time", and "disposed shares".

The taxable deficit reduction, in respect of the corporation resident in Canada, of a particular relevant foreign affiliate of the corporation resident in Canada, in respect of disposed shares, is

- if the particular relevant foreign affiliate has, at the balance adjustment time, an amount of taxable surplus, in respect of the corporation resident in Canada, and the particular foreign affiliate of the corporation resident in Canada that issued the disposed shares (the "issuing foreign affiliate") has, at the balance adjustment time, consolidated taxable surplus (as this amount is determined under paragraph 5902(1)(*c*)), in respect of the corporation resident in Canada, in respect of the disposition of the disposed shares that exceeds the amount of the issuing foreign affiliate's consolidated taxable deficit (as this amount is determined under paragraph 5902(1)(*d*)), in respect of the corporation resident in Canada, in respect of the disposition of the disposed shares, the amount determined by the formula

$$A/B \times C/D$$

where

A is the portion of the amount of the particular relevant foreign affiliate's taxable surplus, in respect of the corporation resident in Canada, at the balance adjustment time, that can reasonably be considered to have been included in computing the amount of the issuing foreign affiliate's consolidated taxable surplus (as this amount is determined under paragraph 5902(1)(*c*)), in respect of the corporation resident in Canada, as a result of the disposition of the disposed shares,

B is calculated as the amount of the particular foreign affiliate's consolidated taxable surplus (as this amount is determined under paragraph 5902(1)(*c*)), in respect of the corporation resident in Canada, in respect of the disposition of the disposed shares,

C is calculated as the amount of the particular foreign affiliate's consolidated taxable deficit (as this amount is determined under paragraph 5902(1)(*d*)), in respect of the corporation resident in Canada, in respect of the disposition of the disposed shares, and

D is, where the particular relevant foreign affiliate is the issuing foreign affiliate, 1, and, where the particular relevant foreign affiliate is not the issuing foreign affiliate, the surplus entitlement percentage of the issuing foreign affiliate, in respect of the particular relevant foreign affiliate, that, under subsections 5905(10) to (13), would be determined, at the balance adjustment time, if the issuing foreign affiliate were the "corporation resident in Canada" referred to in those subsections and the particular relevant foreign affiliate were the "particular foreign affiliate" referred to in those subsections;

- if the amount determined, in respect of the particular relevant foreign affiliate, for the description of any of A, B or D in the formula is nil, the amount determined by the formula is deemed to be nil; and

- if the particular relevant foreign affiliate has, at the balance adjustment time, an amount of taxable surplus in respect of the corporation resident in Canada and the issuing foreign affiliate has, at that time, an amount of consolidated taxable deficit (as this amount is determined under paragraph 5902(1)(*d*)), in respect of the corporation resident in Canada, as a result of the disposition that is equal to or greater than the amount of the issuing foreign affiliate's consolidated taxable surplus (as this amount is determined under paragraph 5902(1)(*d*)), in respect of the corporation resident in Canada, in respect of the disposition of the disposed shares, the amount of that taxable surplus.

**"taxable surplus reduction"**

ITR
5905(21)

New subsection 5905(21) of the Regulations defines the expression "taxable surplus reduction", which determines the reduction of the taxable surplus, in respect of the corporation resident in Canada, of a particular relevant foreign affiliate in respect of the disposition dividend of the issuing foreign affiliate where the issuing foreign affiliate has consolidated taxable surplus in excess of consolidated taxable deficit in respect of the corporation resident in Canada. The subsection adopts, from subsection 5905(8) of the Regulations, the terms "particular relevant foreign affiliate", "balance adjustment time", "disposed shares" and "disposition dividend".

The taxable surplus reduction, in respect of the corporation resident in Canada, of a particular relevant foreign affiliate of the corporation resident in Canada, in respect of disposed shares, is

- the amount determined by the formula

$$A/B \times C \times D$$

where

A is the portion of the amount of the particular relevant foreign affiliate's taxable surplus, in respect of the corporation resident in Canada, at the balance adjustment time, that can reasonably be considered to have been included in computing the amount of the consolidated taxable surplus (as this amount is determined under paragraph 5902(1)(*c*)), in respect of the corporation resident in Canada, in respect of the disposition of the disposed shares, of the foreign affiliate of the corporation resident in Canada that issued the disposed shares (the "issuing foreign affiliate"),

B the amount of the particular foreign affiliate's consolidated taxable surplus (as this amount is determined under paragraph 5902(1)(*c*)), in respect of the corporation resident in Canada resident, as a result of the disposition of the disposed shares,

C is the portion of the disposition dividend that is, because of an election made under subsection 93(1) or (1.2) of the Act, in respect of the disposition of the disposed shares, received on the disposed shares by the person disposing of those shares, that is prescribed by paragraph 5900(1)(*b*) to have been paid out of the

issuing foreign affiliate's taxable surplus, in respect of the corporation resident in Canada, and

D is the specified adjustment factor, in respect of the corporation resident in Canada, in respect of the particular relevant foreign affiliate, of the person disposing of the disposed shares;

- if the amount determined for either A or B of the formula is nil, the amount of determined by the formula is nil; and
- if an amount is determined in respect of the particular relevant foreign affiliate under paragraph (*b*) of subsection 5905(20) (which subsection defines the expression "taxable deficit reduction"), the amount determined by the formula is deemed to be nil.

**"underlying foreign tax reduction"**

ITR
5905(22)

New subsection 5905(22) of the Regulations defines the expression "underlying foreign tax reduction", which determines the reduction of underlying foreign tax, in respect of the corporation resident in Canada, of a particular relevant foreign affiliate that is attributable to total deductions from the taxable surplus of the particular relevant foreign affiliate as a result of a taxable deficit reduction and an exempt deficit allocation. The subsection adopts, from subsection 5905(8) of the Regulations, the terms "particular relevant foreign affiliate", "balance adjustment time", "disposed shares" and "disposition dividend".

Underlying foreign tax reduction in respect of the corporation resident in Canada, of a particular relevant foreign affiliate of the corporation resident in Canada, in respect of the disposition of the disposed shares, is the amount determined by the formula

$$A \times (B + C)/D$$

where

A is the underlying foreign tax in respect of the corporation resident in Canada of the particular relevant foreign affiliate, at the balance adjustment time,

B is the taxable deficit reduction, in respect of the corporation resident in Canada, of the particular relevant foreign affiliate of the corporation resident in Canada, in respect of the disposition of the disposed shares,

C is the exempt deficit allocation, in respect of the corporation resident in Canada, of the particular relevant foreign affiliate of the corporation resident in Canada, in respect of the disposition of the disposed shares, and

D is the taxable surplus in respect of the corporation resident in Canada of the particular relevant foreign affiliate, at the balance adjustment time.

**"specified adjustment factor"**

ITR
5905(23)

New subsection 5905(23) of the Regulations defines the expression "specified adjustment factor", which is used in subsection 5905(8) of the Regulations and the definitions "exempt surplus reduction" and "taxable surplus reduction" in subsections 5905(18) and (21), respectively. The subsection adopts, from subsection 5905(8) of the Regulations, the terms "particular relevant foreign affiliate" and "disposed shares".

Specified adjustment factor in respect of a corporation resident in Canada of a particular relevant foreign affiliate of that corporation resident in Canada in respect of disposed shares is the amount determined by the formula

$$A/B$$

where

A is, where the corporation resident in Canada disposed of the disposed shares, 100 per cent, and, where another foreign affiliate of the corporation resident in Canada disposed of the disposed shares, the surplus entitlement percentage of the corporation resident in Canada in respect of that other foreign affiliate, immediately before the disposition of the disposed shares, and

B is the surplus entitlement percentage of the corporation resident in Canada in respect of the particular relevant foreign affiliate, immediately before the disposition of the disposed shares.

ITR
5907

Section 5907 of the Regulations provides definitions and rules for the purposes of Part LIX of the Regulations.

ITR
5907(1)

Subsection 5907(1) of the Regulations provides definitions for the purposes of Part LIX of the Regulations.

**"earnings"**

The definition "earnings" of a foreign affiliate of a taxpayer resident in Canada for a taxation year in subsection 5907(1) of the Regulations is relevant for the purposes of computing the surpluses and deficits of the affiliate. Paragraph (*b*) of the definition "earnings" in subsection 5907(1) of the Regulations ensures that "earnings" will reflect the total of all amounts by which the affiliate's income for the year from an active business is increased because of paragraph 95(2)(*a*) of the Act.

Consequential to the amendments made to paragraph 95(2)(*a*) of the Act to provide for amounts by which such income of the affiliate could be decreased, paragraph (*b*) of the definition "earnings" in subsection 5907(1) of the Regulations is proposed to be amended to ensure that "earnings" will reflect the total of all amounts required by paragraph 95(2)(*a*) to be included (either as a plus or as a minus) in computing the affiliate's income for the year from an active business. For more detail, refer to the commentary to paragraph 95(2)(*a*).

The amendment to paragraph (*b*) of the definition "earnings" in subsection 5907(1) applies to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002. Note that this amendment is included in the Global Section 95 Election package described at the beginning of the commentary to section 95 of the Act.

**"exempt deficit"**

The definition "exempt deficit" of a foreign affiliate of a taxpayer resident in Canada for a taxation year in subsection 5907(1) of the Regulations is relevant for the purposes of computing the surpluses of the foreign affiliate.

The amendment to the definition "exempt deficit" of a foreign affiliate of a taxpayer resident in Canada for a taxation year in

subsection 5907(1) of the Regulations inserts a reference to new subparagraph (viii) of the description of A in the definition "exempt surplus" in subsection 5907(1) of the Regulations.

The proposed amendment to the definition "exempt deficit" in subsection 5907(1) of the Regulations applies to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002. Note that this amendment is included in the Global Section 95 Election package described at the beginning of the commentary to section 95 of the Act.

**"exempt earnings"**

The definition "exempt earnings", of a foreign affiliate of a particular corporation for a taxation year, in subsection 5907(1) of the Regulations is relevant for the purposes of computing the surpluses and deficits of the affiliate.

The definition contains a number of provisions. Subparagraphs (*d*)(i) and (ii) of the definition "exempt earnings" are relevant to the understanding of the commentary below. Those particular provisions provide as follows:

- Subparagraphs (*d*)(i) and (ii) of the definition "exempt earnings" provide that, where a foreign affiliate of a particular corporation is resident in a designated treaty country, the affiliate's earnings for the year from an active business carried on by it in a designated treaty country and the amounts included in its income from an active business for the year under paragraph 95(2)(*a*) of the Act, respectively, are included in computing its "exempt earnings" for the year.

- Clause (*d*)(ii)(D) of the definition "exempt earnings" includes, in the exempt earnings of a foreign affiliate of a particular corporation, income derived from amounts paid or payable to the affiliate by a partnership of which a non-resident corporation to which the affiliate and the particular corporation are related throughout the year was a member (other than a "specified member" at any time in a fiscal period of a partnership that ends in the year) if that income is deemed by clause 95(2)(*a*)(ii)(A) of the Act to be income from an active business of the affiliate. This will be the case to the extent that the amounts paid or payable would be deductible in computing the exempt earnings or the exempt loss of the partnership if it were a foreign affiliate of a corporation.

- Clause (*d*)(ii)(F) of the definition "exempt earnings" includes, in the exempt earnings of a foreign affiliate of a particular corporation, income derived from amounts paid or payable to the

affiliate by a partnership of which another foreign affiliate of the particular corporation in respect of which the particular corporation has a qualifying interest throughout the year was a member (other than a "specified member" at any time in a fiscal period of a partnership that ends in the year) if that income is deemed by clause 95(2)(*a*)(ii)(B) of the Act to be income from an active business of the affiliate. This will be the case to the extent that the amounts paid or payable would be deductible in computing the exempt earnings or the exempt loss of the partnership if it were a foreign affiliate of a corporation.

- Clause (*d*)(ii)(G) of the definition "exempt earnings" includes, in the exempt earnings of a foreign affiliate of a corporation, income derived from amounts paid or payable to the affiliate by a partnership of which the affiliate was a member (other than a specified member at any time in a fiscal period of a partnership that ends in the year) if that income is deemed by clause 95(2)(*a*)(ii)(C) of the Act to be income from an active business of the affiliate. This will be the case to the extent that the amounts paid or payable would be deductible in computing the exempt earnings or the exempt loss of the partnership if it were a foreign affiliate of a corporation.

- Clause (*d*)(ii)(H) of the definition "exempt earnings" includes, in the exempt earnings of a foreign affiliate of a particular corporation, income derived from amounts paid or payable to it (or to a partnership of which it is a member) by another foreign affiliate (the "second affiliate") of the particular corporation related to it and to the particular corporation throughout the year if that income is deemed by clause 95(2)(*a*)(ii)(D) of the Act to be the income from an active business of the affiliate. The income must be derived from amounts paid or payable in respect of interest on borrowed money used to earn income from property or on an amount payable for property. That property must consist of shares of another foreign affiliate (the "third affiliate") of the particular corporation in respect of which the particular corporation has a qualifying interest throughout the year that are excluded property of the second affiliate. The second affiliate, the third affiliate and "each other affiliate relevant for the purpose of determining whether the shares of the third affiliate are excluded property" must all be resident in, and subject to income taxation in, the same designated treaty country. (The expression "designated treaty country" is defined in subsection 5907(11).) As well, the amounts paid or payable must be relevant in determining the liability for income taxes in the designated treaty country of a group of corporations composed of the second affiliate and one or more other foreign affiliates (the shares of which are excluded property), of the particular corporation, resident in that country and in respect

of which the particular corporation has a qualifying interest throughout the year. For the purposes of making these determinations, two assumptions are made. First, the definition "excluded property" in subsection 95(1) of the Act is to be read without reference to amounts receivable referred to in paragraph (*c*) of that definition where, if interest were payable on the amounts, the interest would not be deductible by the debtor in calculating its exempt earnings or loss. Second, shares of a foreign affiliate (a "non-qualifying affiliate") that is non-resident and subject to income taxation in a designated treaty country are to be ignored in determining whether the shares of the third affiliate are excluded property, unless the shares of the third affiliate would not be excluded property if all shares of all non-qualifying affiliates were not excluded property. For convenience of reference, this second assumption is referred to in the remainder of this commentary to the definition "exempt earnings" as the "Shares Assumption".

As noted in the commentary to new clauses 95(2)(*a*)(ii)(A), (B) and (C) of the Act, those clauses are amended so that the condition requiring the partnership to have a relevant person as a member of the partnership (otherwise than as a specified member of the partnership) is replaced by a requirement that the relevant person to be a "qualifying member" of the partnership throughout each period, in the fiscal period of the partnership, that ends in the year. The expression "qualifying member" is newly defined in subsection 248(1) of the Act as being a person that would at the relevant time be determined to be a qualifying member of the partnership under paragraph 95(2)(*o*) of the Act. For more detail, see the commentary to paragraph 95(2)(*o*) and subsection 248(1) of the Act.

The amendments to clauses 95(2)(*a*)(ii)(A), (B) and (C) of the Act, in conjunction with the new definition "qualifying member", ensure that, in applying those clauses, limited partners and limited partnerships are treated in the same manner as general partners and general partnerships. These amendments also ensure that, even if the activities of the relevant person do not meet the business activity requirements in new subparagraph 95(2)(*o*)(i), a partnership may qualify under clauses 95(2)(*a*)(ii)(A), (B) or (C) if the relevant person has an equity interest in the partnership that meets the criteria set out in new subparagraph 95(2)(*o*)(ii). For more detail, see the commentary to new paragraph 95(2)(*o*) of the Act.

The definition "exempt earnings" is to be amended in the following ways.

First, new paragraph (*a*.1) is added to the definition "exempt earnings" in subsection 5907(1) of the Regulations to include the

untaxed portion of the gain from the sale of excluded property that is eligible capital property.

Second, subparagraph (*d*)(ii) of the definition "exempt earnings" in subsection 5907(1) is amended in the following ways:

- Consequential to the amendments made to paragraph 95(2)(*a*) of the Act, subparagraph (*d*)(ii) of the definition "exempt earnings" in subsection 5907(1) of the Regulations is amended to provide that, in computing the affiliate's "exempt earnings" for the year, there will be included the earnings derived from "amounts required to be included in computing" income from an active business under amended paragraph 95(2)(*a*) of the Act.

- Clauses (*d*)(ii)(D), (F) and (G) of the definition "exempt surplus" in subsection 5907(1) of the Regulations are proposed to be amended consistent with similar amendments made to clauses 95(2)(*a*)(ii)(A), (B) and (C) of the Act. Accordingly, amendments (referred to in this commentary as the "Qualifying Member Amendments") are made to clauses (*d*)(ii)(D), (F) and (G) of the definition "exempt surplus" in subsection 5907(1) of the Regulations so that the condition requiring the partnership to have a relevant person as a member of the partnership (otherwise than as a specified member of the partnership) is replaced by a requirement that the relevant person be a "qualifying member" of the partnership throughout each period, in the fiscal period of the partnership, that ends in the year. The expression "qualifying member" is newly defined in subsection 248(1) of the Act as being a person that would at the relevant time be determined to be a qualifying member of the partnership under paragraph 95(2)(*o*) of the Act. For more detail, see the commentary to paragraphs 95(2)(*o*) and (*q*) and subsection 248(1) of the Act.

- Consistent with the amendments to clause 95(2)(*a*)(ii)(D) of the Act, clause (*d*)(ii)(H) of the definition "exempt earnings" in subsection 5907(1) of the Regulations is proposed to be amended to modify the requirement that the second affiliate, the third affiliate and "each other affiliate relevant for the purpose of determining whether the shares of the third affiliate are excluded property" must each be resident in, and subject to income taxation in, the same designated treaty country (sub-subclause (*d*)(ii)(H)(I)2. of the definition). That requirement is replaced with a requirement that

    - the second affiliate and the third affiliate must be resident in the same designated treaty country for each of their taxation years (each of which taxation years is referred to as a "relevant

taxation year" of the second affiliate or of the third affiliate, as the case may be) that end in the year, and

- in respect of each of the second affiliate and the third affiliate for each relevant taxation year of that affiliate, either that affiliate must be subject to income taxation in that country in that relevant taxation year, or, alternatively, the members or shareholders of that affiliate at the end of that relevant taxation year must be subject to income taxation in that country on, in aggregate, all or substantially all of the income of that affiliate for that relevant taxation year in their taxation years in which that relevant taxation year ends, or would be so subject to income taxation in that country if that affiliate had income for that relevant taxation year and the income of those members or shareholders for their taxation years in which that relevant taxation year ends consisted only of their share of income of that affiliate for that relevant taxation year.

• Further, clause (*d*)(ii)(H) of the definition "exempt earnings" in subsection 5907(1) of the Regulations is proposed to be amended to delete the Shares Assumption. The Shares Assumption is no longer relevant as that clause no longer contains a reference to "each other affiliate relevant for the purpose of determining whether the shares of the third affiliate are excluded property".

• Consequential to the introduction of new subparagraph 95(2)(*a*)(v) of the Act, new clause (*d*)(ii)(L) of the definition "exempt earnings" in subsection 5907(1) of the Regulations is proposed to be added. New clause (*d*)(ii)(L) ensures that income of a foreign affiliate, of a corporation, for a year that, because of new subparagraph 95(2)(*a*)(v) of the Act, is included in computing the affiliate's active business income for the year, is included in computing the "exempt earnings" of the affiliate. In making the determination of this income, new subparagraph 95(2)(*a*)(v) is to be read as if it applies to the income or loss derived from the disposition of excluded property that is not capital property if

- that property is used or held by the particular foreign affiliate for the purpose of gaining or producing income from property that would, because of this paragraph, be included in computing the particular foreign affiliate's income from an active business if this paragraph were read without reference to this subparagraph, and

- that income or loss is derived, directly or indirectly, from amounts paid or payable to the particular foreign affiliate by another foreign affiliate of the taxpayer, or by a non-resident corporation related to the particular foreign affiliate and the

taxpayer, that is in respect of an active business carried on in a designated treaty country (as defined for the purpose of Part LIX of the Regulations).

- Consequential to the introduction of new subparagraph 95(2)(*a*)(vi) of the Act, new clause (*d*)(ii)(M) of the definition "exempt earnings" in subsection 5907(1) of the Regulations is proposed to be added. New clause (*d*)(ii)(M) ensures that income of a foreign affiliate, of a corporation, for a year that, because of new subparagraph 95(2)(*a*)(vi) of the Act, is included in computing the affiliate's active business income for the year, is included in computing the "exempt earnings" of the affiliate. This is determined by reading new subparagraph 95(2)(*a*)(vi) as the income or loss derived from the disposition of excluded property that is not capital property if derived by the particular foreign affiliate under or as a result of an agreement that provides for the purchase, sale or exchange of currency and that can reasonably be considered to have been made by the particular foreign affiliate to reduce its risk, of fluctuations in the value of the denominated currency, with respect to

  - income or loss from property that is

    - because of this paragraph included in computing the particular foreign affiliate's income or loss from an active business if this paragraph were read without reference to this subparagraph, and

    - derived, directly or indirectly, from amounts paid or payable to the particular foreign affiliate by another foreign affiliate of the taxpayer, or by a non-resident corporation related to the particular foreign affiliate and the taxpayer, that is in respect of an active business carried on in a designated treaty country (as defined for the purpose of Part LIX of the Regulations), or

  - excluded property the income or loss from which, if there were income or a loss, described in subparagraph 95(2)(*a*)(i).

For more detail, see the commentary to subsection 95(2) of the Act.

The amendments to paragraph (*a*.1), and subparagraph (*d*)(ii), of the definition "exempt earnings" in subsection 5907(1) apply to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002. Note that these amendments are included in the Global Section 95 Election package described in the beginning of the commentary to section 95 of the Act and that, in the event of a Global Section 95 Election, the Qualifying Member Amendments

apply to taxation years, of a foreign affiliate of a taxpayer, that end after 1999.

**"exempt loss"**

The definition "exempt loss" of a foreign affiliate of a corporation for a taxation year in subsection 5907(1) of the Regulations is relevant for the purposes of computing the surpluses and deficits of the affiliate.

The definition "exempt loss" in subsection 5907(1) is proposed to be amended in the following ways.

First, consequential to the proposed amendments to paragraph (*c*) of that definition, the "preamble" of that definition is proposed to be amended to refer to the foreign affiliate as the "particular" foreign affiliate.

Second, amendments are proposed to be made to paragraph (*c*) of the definition "exempt loss" in subsection 5907(1). Under existing paragraph (*c*) of the definition, where a particular foreign affiliate of a particular corporation is resident in a designated treaty country, the affiliate's losses for a year from an active business carried on by it in Canada or in a designated treaty country are included in computing its "exempt loss" for the year. Consequential to the amendments made to paragraph 95(2)(*a*) of the Act, paragraph (*c*) of the definition is proposed to be amended to ensure that losses from sources in a country, other than Canada, that would otherwise be property losses but are re-characterized by paragraph 95(2)(*a*) to be losses from an active business, are included in computing the "exempt loss" of the affiliate. The provisions to deal with these re-characterized losses are set out in new subparagraph (*c*)(ii) of the definition "exempt loss" and are modelled after the analogous provisions in proposed amended subparagraph (*d*)(ii) of the definition "exempt income" in subsection 5907(1) of the Regulations.

Third, a "postamble" to the definition "exempt loss" in subsection 5907(1) is proposed to be added to ensure that the amount that would otherwise be the "exempt loss" of a foreign affiliate of a particular corporation is reduced by the portion of any income or profits tax refunded by the government of a country for the year to the affiliate that can reasonably be regarded as tax refunded in respect of losses referred to in new subparagraph (*c*)(ii) of the definition "exempt loss" in subsection 5907(1).

The amendments to the definition "exempt loss" in subsection 5907(1) apply to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002. Note that these amendments are

included in the Global Section 95 Election package described at the beginning of the commentary to section 95 of the Act, and that, in the event of a Global Section 95 Election, in its application to taxation years, of a foreign affiliate of a taxpayer, that end before 2000, the Member Criteria Condition will, instead of containing the Qualifying Member Requirement, contain the requirement that the partnership have a relevant person as a member of the partnership (otherwise than as a specified member of the partnership).

The expression "specified member" is defined in existing subsection 248(1) of the Act. For more detail, see the commentary to the definition "exempt earnings" in subsection 5907(1) of the Regulations.

**"exempt surplus"**

The definition "exempt surplus" of a foreign affiliate of a taxpayer resident in Canada for a taxation year in subsection 5907(1) of the Regulations is relevant for the purposes of computing the surpluses and deficits of the affiliate. The definition is amended in three ways.

Firstly, the Regulations are proposed to be amended by replacing, with any grammatical changes that the circumstances require, every reference to "subsection 5905(7)" with a reference to "subsections 5905(7) to (7.4)" in the following subparagraphs of the description of A in the following definitions in subsection 5907(1) of the Regulations:

- subparagraph (iii) of the description of A in the definition "exempt surplus";

- subparagraph (iii) of the description of A in the definition "taxable surplus"; and

- subparagraph (iv) of the description of A in the definition "underlying foreign tax".

This amendment to the Regulations is to be effected by way of a global provision in the amending Regulation rather than by having the amending Regulation amend, provision by provision, each specific provision in the Regulations where a reference to subsection 5905(7) appears. This amendment to the Regulations is consequential to the division of subsection 5905(7) of the Regulations into subsections 5905(7) to (7.4). For more detail, refer to the commentary to subsections 5905(7), (7.1) and (7.2) to (7.4).

Secondly, the definition "exempt surplus" of a foreign affiliate of a taxpayer resident in Canada for a taxation year in subsection 5907(1)

of the Regulations is amended to include each amount determined under subparagraph 5905(2)(*a*)(iv), (4)(*a*)(iv), (6)(*a*)(iv) or (8)(*a*)(iv) in the period and before the particular time in the description of A of the definition.

Thirdly, the definition "exempt surplus" of a foreign affiliate of a taxpayer resident in Canada for a taxation year in subsection 5907(1) of the Regulations is amended to include each amount determined under subparagraph 5905(2)(*a*)(i), (4)(*a*)(i), (6)(*a*)(i) or (8)(*a*)(i) in the period and before the particular time, in the description of B of the definition.

**"loss"**

The definition "loss" of a foreign affiliate of a taxpayer resident in Canada for a taxation year in subsection 5907(1) of the Regulations is relevant for the purposes of computing the surpluses and deficits of the foreign affiliate.

Consequential to the amendments to paragraph 95(2)(*a*) of the Act, the definition "loss" in subsection 5907(1) of the Regulations is proposed to be amended to add new paragraph (*b*) to ensure that losses from sources in a country other than Canada, that would otherwise be property losses but are re-characterized by paragraph 95(2)(*a*) of the Act to be losses from an active business, are included in computing the "loss" of the affiliate.

The amendment to the definition "loss" in subsection 5907(1) is proposed to apply to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002. Note that these amendments are included in the Global Section 95 Election package described at the beginning of the commentary to section 95 of the Act.

**"net earnings"**

The definition "net earnings" of a foreign affiliate of a taxpayer resident in Canada for a taxation year in subsection 5907(1) of the Regulations is relevant for the purposes of computing the surpluses and deficits of the foreign affiliate.

It is proposed to amend paragraph (*d*) of the definition "net earnings". The amendment is to subparagraph (*d*)(i) and is consequential to the amendments to the definition "foreign accrual property income" in subsection 95(1) of the Act. Those amendments to the definition "foreign accrual property income" ensure that capital gains and losses from dispositions of "excluded property" to which subsection 88(3) of the Act applies are included in computing foreign accrual property

income. This amendment to the definition "net earnings" ensures that, in computing net earnings, those capital gains are not double-counted.

The proposed amendment to the definition "net earnings" in subsection 5907(1) of the Regulations applies to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002. Note that this amendment is included in the Global Section 95 Election package described at the beginning of the commentary to section 95 of the Act.

**"net loss"**

The definition "net loss" of a foreign affiliate of a taxpayer resident in Canada for a taxation year in subsection 5907(1) of the Regulations is relevant for the purposes of computing the surpluses and deficits of the foreign affiliate.

It is proposed to amend paragraph (*d*) of the definition "net loss". The amendment is to subparagraph (*d*)(i) of the definition "net loss". The amendment removes the reference to the words in parentheses that were previously contained in that subparagraph. They were not necessary and caused confusion.

The proposed amendment to the definition "net loss" in subsection 5907(1) of the Regulations applies to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002. Note that this amendment is included in the Global Section 95 Election package described at the beginning of the commentary to section 95 of the Act.

**"taxable deficit"**

The definition "taxable deficit" of a foreign affiliate of a taxpayer resident in Canada for a taxation year in subsection 5907(1) of the Regulations is relevant for the purposes of computing the surpluses of the foreign affiliate.

The amendment to the definition "taxable deficit" of a foreign affiliate of a taxpayer resident in Canada for a taxation year in subsection 5907(1) of the Regulations is to insert a reference to new subparagraph (vi) of the description of A in the definition "taxable surplus" in subsection 5907(1) of the Regulations.

The proposed amendment to the definition "taxable deficit" in subsection 5907(1) of the Regulations applies to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002. Note that this amendment is included in the Global Section 95

Election package described at the beginning of the commentary to section 95 of the Act.

**"taxable earnings"**

The definition "taxable earnings" of a foreign affiliate of a taxpayer resident in Canada for a taxation year in subsection 5907(1) of the Regulations is relevant for the purposes of computing the surpluses of the foreign affiliate.

The proposed amendment of the definition "taxable earnings" in subsection 5907(1) of the Regulations is to subparagraph (*b*)(v) and is consequential to the amendments to the definition "foreign accrual property income" in subsection 95(1) of the Act. The amendments to the definition "foreign accrual property income" ensure that capital gains and losses from dispositions of "excluded property" to which subsection 88(3) of the Act applies are included in computing foreign accrual property income. This amendment to the definition "taxable earnings" ensures that, in computing taxable earnings, those capital gains are not double-counted.

This amendment to the definition "taxable earnings" in subsection 5907(1) of the Regulations applies to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002. Note that this amendment is included in the Global Section 95 Election package described at the beginning of the commentary to section 95 of the Act.

**"taxable loss"**

The definition "taxable loss" of a foreign affiliate of a taxpayer resident in Canada for a taxation year in subsection 5907(1) of the Regulations is relevant for the purposes of computing the surpluses and deficits of the foreign affiliate.

As noted in the commentary to the proposed amendments to the definition "loss" in subsection 5907(1), a property loss re-characterized by paragraph 95(2)(*a*) of the Act as loss from an active business is described in new paragraph (*b*) of the definition "loss" and is included in computing "loss".

The amendment to the definition "taxable loss" in subsection 5907(1) of the Regulations proposes to add new subparagraph (*b*)(v). That subparagraph ensures that, to the extent that the loss for the year determined under paragraph (*b*) of the definition "loss" has not been included under existing subparagraph (*b*)(i) of the definition "taxable loss" or deducted in computing an amount under existing subparagraph (*b*)(i) of the definition "taxable earnings", that loss

(minus the portion of any income or profits tax refunded by the government of a country for the year that can reasonably be regarded as tax refunded in respect of that loss) is to be included in computing "taxable loss" for the year. Note, also, that the existing "postamble" to the definition "taxable loss" ensures that "taxable loss" does not include any amount included in the affiliate's "exempt loss" for the year.

This proposed amendment to the definition "taxable loss" in subsection 5907(1) of the Regulations applies to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002. Note that this amendment is included in the Global Section 95 Election package described at the beginning of the commentary to section 95 of the Act.

**"taxable surplus"**

The definition "taxable surplus" of a foreign affiliate of a taxpayer resident in Canada for a taxation year in subsection 5907(1) of the Regulations is relevant for the purposes of computing the surpluses and deficits of the foreign affiliate.

The definition "taxable surplus" of a foreign affiliate of a taxpayer resident in Canada for a taxation year in subsection 5907(1) of the Regulations is proposed to be amended in three ways.

Firstly, in the description of A in the definition of "taxable surplus" of a foreign affiliate of a taxpayer resident in Canada for a taxation year in subsection 5907(1), there is to be included a new subparagraph (vi) which will include in the description of A of the definition each amount determined under subparagraph 5905(2)(*a*)(v), (4)(*a*)(v), (6)(*a*)(v) or (8)(*a*)(v) in the period and before that particular time.

Secondly, in subparagraph (v) of the description of B in the definition "taxable surplus" of a foreign affiliate of a taxpayer resident in Canada for a taxation year in subsection 5907(1), the reference to "paragraph 5902(4)(*b*) or subparagraph 5905(2)(*a*)(ii), (6)(*a*)(ii) or (8)(*a*)(ii)" is replaced by a reference to "subparagraph 5905(2)(*a*)(ii), (4)(*a*)(ii), (6)(*a*)(ii) or (8)(*a*)(ii)".

For details on the third amendment, refer to the commentary to the definition "exempt surplus" in subsection 5907(1).

These proposed amendments to the definition "taxable surplus" in subsection 5907(1) of the Regulations apply in respect of dispositions in respect of an election in respect of which proposed new subsection 5902(1) applies.

**"underlying foreign tax"**

The definition "underlying foreign tax" of a foreign affiliate of a corporation resident in Canada, in respect of a corporation, in subsection 5907(1) of the Regulations is relevant for the purposes of computing the surpluses and deficits of the foreign affiliate.

Subparagraph (iii) of the description of B of the definition "underlying foreign tax" has been amended to remove the reference to paragraph 5902(4)(*c*), and to add a reference to subparagraph 5905(4)(*a*)(iii).

This proposed amendment to the definition "underlying foreign tax" in subsection 5907(1) of the Regulations applies in respect of dispositions in respect of which an election was made in respect of which proposed new subsection 5902(1) applies.

**"whole dividend"**

The definition "whole dividend" paid at any time on the shares of a class of the capital stock of a foreign affiliate of a taxpayer resident in Canada in subsection 5907(1) of the Regulations is relevant for the purposes of computing the surpluses and deficits of the foreign affiliate.

The proposed amendment to paragraph (*b*) of the definition "whole dividend" in subsection 5907(1) replaces a reference to "5902(1)(*c*)" with a reference to "5902(1)(*g*)".

This proposed amendment to the definition "underlying foreign tax" in subsection 5907(1) of the Regulations applies in respect of dispositions in respect of which an election was made in respect of which proposed new subsection 5902(1) applies.

ITR
5907(1.1)

Subsection 5907(1.1) of the Regulations contains rules for the calculation of the surpluses and deficits of a foreign affiliate of a corporation resident in Canada where the affiliate is a member of a group (the "consolidated group") of foreign affiliates of the corporation that files a consolidated or combined return in a foreign country such as the United States and one of the affiliates (the "primary affiliate") in the group is responsible, on behalf of the group, for paying, or claiming a refund of, the tax payable in that country by the primary affiliate and the other members of the group (those other members being referred to as the "secondary affiliates").

Subparagraph 5907(1.1)(*b*)(ii) applies where a secondary affiliate has a loss and the primary affiliate pays an amount to a secondary affiliate in respect of a reduction or refund, by virtue of the loss of the secondary affiliate, of the tax that would otherwise have been payable in the country by the primary affiliate for the year on behalf of the consolidated group. In general terms, that subparagraph results in a reduction of the primary affiliate's surplus balances, and an increase of the secondary affiliate's surplus balances, by the amount of the payment.

The proposed amendments to subparagraph 5907(1.1)(*b*)(ii) deal with the case where a secondary affiliate has a tax credit and the primary affiliate pays an amount to the secondary affiliate in respect of a reduction or refund, by virtue of the tax credit of the secondary affiliate, of the tax that would otherwise have been payable in the country by the primary affiliate for the year on behalf of the consolidated group. In general terms, the amendments ensure that the primary affiliate's surplus balances are reduced, and the secondary affiliate's surplus balances are increased, by the amount of the payment.

The amendments to subparagraph 5907(1.1)(*b*)(ii) apply to payments made after December 20, 2002.

ITR
5907(2)(*f*)

Subsection 5907(2) of the Regulations provides special rules for computing earnings of a foreign affiliate from an active business carried on by it in a country. It is proposed to amend paragraph 5907(2)(*f*) to delete subparagraph (ii) consequential to the introduction of the rules in paragraphs 95(2)(*c*.2) to (*c*.6), and 95(2)(*f*.3) to (*f*.8) of the Act.

The amendment to paragraph 5907(2)(*f*) applies in respect of dispositions by a foreign affiliate after December 20, 2002, other than a disposition made after December 20, 2002 under a written agreement made by the foreign affiliate before December 20, 2002.

ITR
5907(2.01)

New subsection 5907(2.01) of the Regulations provides that, notwithstanding any other provision of the Regulations, in determining the earnings of a foreign affiliate of a corporation resident in Canada, the cost of a property that was acquired by a particular person or partnership from another person or partnership (the "vendor") in respect of which any of paragraphs 5907(2)(*c*.2),

(*d*), (*e*), (*e*.3) to (*e*.5) and (*f*.4) of the Regulations applied to the vendor in respect of the disposition of the property to the particular person or partnership, is to be determined using the rules in those paragraphs.

New subsection 5907(2.01) of the Regulations applies in respect of dispositions made by a foreign affiliate after December 20, 2002, other than a disposition made after December 20, 2002 under a written agreement made by the foreign affiliate before December 20, 2002.

ITR
5907(2.7)

In general terms, subsection 5907(2.7) of the Regulations provides that, where amounts are included by subparagraph 95(2)(*a*)(i) or (ii) of the Act in computing the income or loss from an active business of a particular foreign affiliate of a taxpayer and these amounts are in respect of amounts paid or payable to the particular affiliate by another non-resident corporation or partnership in the group, the amounts paid or payable to the particular affiliate by the other non-resident corporation or partnership are required to be deducted in computing the other non-resident corporation's or partnership's earnings or loss from an active business (unless they have already been deducted under paragraph 5907(2)(*j*) of the Regulations) for the earliest taxation year in which the amounts were paid or payable.

Subsection 5907(2.7) of the Regulations is proposed to be amended so that it applies to amounts included in computing the income or loss from an active business of the particular affiliate under paragraph 95(2)(*a*) of the Act, rather than just under subparagraph 95(2)(*a*)(i) or (ii).

The proposed amendments to subsection 5907(2.7) of the Regulations apply to taxation years, of a foreign affiliate of a taxpayer, that begin on or after December 20, 2002. Note that these amendments are included in the Global Section 95 Election package described at the beginning of the commentary to section 95 of the Act.

ITR
5907(2.8) to (2.83)

Under clause 95(2)(*a*)(ii)(D) of the Act, the income of a foreign affiliate of a corporation resident in Canada (the "first affiliate") that is derived from amounts paid or payable to it by another foreign affiliate of the corporation or a non-resident corporation to which the first affiliate and the corporation resident in Canada are related (referred to in subsections 5907(2.8) to (2.83) of the Regulations as

the "second affiliate") is included in the active business income of the first affiliate.

The amounts paid or payable by the second affiliate must be in respect of interest on borrowed money used for the purpose of earning income from property or on an amount payable for property where the property consists of shares of another foreign affiliate of the corporation in respect of which the corporation has a qualifying interest throughout the year (in subsections 5907(2.8) to (2.83), the "third affiliate") that are excluded property of the second affiliate within the meaning assigned by section 95 of the Act in the country in which the second affiliate is resident and subject to income taxation.

It is proposed that existing subsection 5907(2.8) of the Regulations be replaced by proposed new subsections 5907(2.8) to (2.83) because of the proposed amendments to clause 95(2)(*a*)(ii)(D) of the Act. These are essentially rules for reducing exempt surplus of foreign affiliates of a taxpayer resident in Canada in respect of interest referred to in 95(2)(*a*)(ii)(D) of the Act. The proposed new subsections apply to taxation year, of foreign affiliate of a taxpayer, to which proposed new clauses 95(2)(*a*)(ii)(D)(III) to (V) of the Act apply.

Proposed subsection 5907(2.8) of the Regulations sets out, in respect of a particular amount of interest referred to in 95(2)(*a*)(ii)(D) of the Act, the requirements for new subsection 5907(2.81) to apply.

Proposed subsection 5907(2.8) provides that subsection 5907(2.81) applies to the specified foreign affiliates of a corporation resident in Canada, if

- an amount in respect of the particular amount of interest is included, under clause 95(2)(*a*)(ii)(D) of the Act, in computing the income or loss for a particular taxation year from an active business of a particular foreign affiliate of the corporation resident in Canada or a person related to the corporation resident in Canada, and

- the particular amount of interest is an amount of interest paid or payable to the particular foreign affiliate, by the second affiliate, under a legal obligation to pay interest on borrowed money used for the purpose of earning income from property, or on an amount payable for property acquired for the purpose of gaining or producing income from property, if

  - the property is excluded property of the second affiliate that is shares of the third affiliate, and

- the requirements set out in clauses 95(2)(*a*)(ii)(D)(IV) and (V) of the Act are satisfied in respect of the second and third affiliates for their respective applicable taxation years.

If subsection 5907(2.81) of the Regulations applies, in respect of the particular amount of interest referred to in subsection 5907(2.8), to the specified foreign affiliates of the corporation resident in Canada, the following rules apply:

- Where the specified foreign affiliate is the second affiliate referred to in subsection 5907(2.8), the particular amount of interest is to be deducted in computing the specified foreign affiliate's exempt surplus at the end of the applicable taxation year of the specified foreign affiliate, to the extent of the specified foreign affiliate's available exempt surplus amount in respect of the applicable taxation year of the specified foreign affiliate.

- Where the specified foreign affiliate is the third affiliate referred to in subsection 5907(2.8), there shall be deducted in computing the specified foreign affiliate's exempt surplus at the end of the applicable taxation year of the specified foreign affiliate, the lesser of the specified foreign affiliate's available exempt surplus amount in respect of the applicable taxation year of the specified foreign affiliate and the amount determined by the formula

$$(A - B) \times C$$

where

A is the particular amount of interest,

B is the amount deducted because of paragraph 5907(2.81)(*a*) in computing the second affiliate's exempt surplus at the end of the applicable taxation year of the second affiliate, and

C is the specified adjustment factor, in respect of the corporation resident in Canada, in respect of the specified foreign affiliate, in respect of the applicable taxation year of the second affiliate.

- Where the specified foreign affiliate is a group foreign affiliate (defined in subsection referred to in subsection 5907(2.84)), there shall be deducted in computing the specified foreign affiliate's exempt surplus in respect of the corporation resident in Canada at the end of the applicable taxation year of the specified foreign affiliate, the lesser of the specified foreign affiliate's available exempt surplus (defined in subsection referred to in subsection 5907(2.83)) in respect of its applicable taxation year and the amount determined by the formula

$$(A - B - C) \times D$$

where

A is the particular amount of interest,

B is the amount deducted because of paragraph 5907(2.81)(*a*) in computing the second affiliate's exempt surplus at the end of the applicable taxation year of the second affiliate,

C is the amount determined when the amount deducted because of paragraph 5907(2.81)(*b*) in computing the third affiliate's exempt surplus at the end of the applicable taxation year of the third affiliate is divided by the amount determined for C in the formula in paragraph 5907(2.81)(*b*) in respect of the third affiliate, and

D is the specified adjustment factor, in respect of the corporation resident in Canada, in respect of the specified foreign affiliate, in respect of the applicable taxation year of the second affiliate.

- Amounts in respect of the particular amount of interest must be deducted under paragraph 5907(2.81)(*a*) to (*c*) that subsection in computing the exempt surplus in respect of the corporation resident in Canada of the specified foreign affiliates of the corporation resident in Canada at the end of each of their applicable taxation years to the extent of the total of all amounts each of which is the available exempt surplus amount of a specified foreign affiliate of the corporation resident in Canada in respect of the applicable taxation year of that specified foreign affiliate.

- An exempt surplus reduction is to be applied against the second affiliate before it is applied against the third affiliate and is to be applied against the third affiliate before it is applied against a group foreign affiliate of the corporation resident in Canada.

- There is to be added in computing the exempt deficit in respect of the corporation resident in Canada of the second affiliate the amount determined by the formula:

$$K - (L + M + N)$$

where

K is the particular amount of interest,

L is the amount determined under paragraph 5907(2.81)(*a*) in respect of the particular amount of interest in respect of the second affiliate,

M is the amount determined when the amount determined under paragraph 5907(2.81)(*b*) in respect of the particular amount of interest in respect of the third affiliate is divided by the amount determined for C in the formula in that paragraph, and

N is the amount determined when the amount determined under paragraph 5907(2.81)(*c*) in respect of the particular amount of interest in respect of the group foreign affiliate is divided by the amount determined for D in the formula in that paragraph.

Proposed subsection 5907(2.82) of the Regulations provides that, in computing the second affiliate's income or loss for a taxation year from any source, no amount is to be deducted in respect of an amount paid or payable by it that is referred to in paragraph 5907(2.81)(*a*).

Proposed subsection 5907(2.83) of the Regulations sets out certain definitions used in subsections 5907(2.8) to (2.83).

**"applicable taxation year"**

"Applicable taxation year" of a specified foreign affiliate of the corporation resident in Canada, in subsection 5907(2.83) of the Regulations, is the last taxation year of the specified foreign affiliate that ends in the particular taxation year of the particular foreign affiliate referred to in paragraph 5907(2.8)(*a*).

**"available exempt surplus amount"**

"Available exempt surplus amount" of a specified foreign affiliate of the corporation resident in Canada, in subsection 5907(2.83) of the Regulations in respect of the applicable taxation year of the specified foreign affiliate is the amount determined by the formula

$$(A + B + C) - (D + E + F + G)$$

where

A is the total of all amounts of which is this portion the specified foreign affiliate's income, for its applicable taxation year, from an active business that is included in computing the exempt earnings in respect of the corporation resident in Canada of the specified foreign affiliate,

B is the specified foreign affiliate's exempt surplus in respect of the corporation resident in Canada at the end of the specified foreign affiliate's taxation year that immediately precedes its applicable taxation year,

C is the total of all amounts each of which is the portion of any dividend received in the applicable taxation year, by the specified foreign affiliate from another foreign affiliate of the corporation resident in Canada, that is prescribed by paragraph 5900(1)(*a*) to have been paid out of that other affiliate's exempt surplus,

D is the total of all amounts each of which is the portion of the specified foreign affiliate's loss, for its applicable taxation year, from an active business that is included in computing the exempt loss in respect of the corporation resident in Canada of the specified foreign affiliate,

E is the specified foreign affiliate's exempt deficit in respect of the corporation resident in Canada at the end of the specified foreign affiliate's taxation year that immediately precedes its applicable taxation year,

F is the specified foreign affiliate's taxable deficit in respect of the corporation resident in Canada at the end of the specified foreign affiliate's taxation year that immediately precedes its applicable taxation year, and

G is the total of all amounts each of which is the portion of any dividend paid in the applicable taxation year by the specified foreign affiliate that is prescribed by paragraph 5900(1)(*a*) to have been paid out of its exempt surplus.

**"group foreign affiliate"**

"Group foreign affiliate", at any time, of a corporation resident in Canada, in subsection 5907(2.83) of the Regulations, is any of its foreign affiliates (other than the second affiliate and the third affiliate) in which the second affiliate has, at that time, an equity percentage.

**"specified adjustment factor"**

"Specified adjustment factor", in respect of the corporation resident in Canada, in subsection 5907(2.83) of the Regulations, in respect of a specified foreign affiliate of the corporation resident in Canada, in

respect of the applicable taxation year of the second affiliate, is the amount determined by the formula

$$A/B$$

where

A is the surplus entitlement percentage of the corporation resident in Canada in respect of the second affiliate, immediately before the end of the applicable taxation year of the second affiliate, and

B is the surplus entitlement percentage of the corporation resident in Canada in respect of the specified foreign affiliate, immediately before the end of the applicable taxation year of the second affiliate.

**"specified foreign affiliate"**

"Specified foreign affiliate" of the corporation resident in Canada, in subsection 5907(2.83), is any foreign affiliate of the corporation resident in Canada that, at the end of the particular taxation year referred to in paragraph 5907(2.8)(*a*) of the Regulations, is

- the second affiliate,
- the third affiliate, or
- another corporation that is
  - if there is only one group foreign affiliate of the corporation resident in Canada at the end of that particular taxation year, that group foreign affiliate, or
  - if there is more than one group foreign affiliate of the corporation resident in Canada at the end of that particular taxation year, the group foreign affiliate of the corporation resident in Canada with the greatest available exempt surplus amount for the applicable taxation year of that group foreign affiliate.

ITR
5907(2.9)

Subsection 5907(2.9) of the Regulations applies where the fresh start rules in paragraph 95(2)(*k*) of the Act apply to a foreign affiliate of a corporation resident in Canada in respect of a "foreign business".

Subsection 5907(2.9) ensures that appropriate adjustments are made to the surplus accounts of the affiliate.

In general terms, subsection 5907(2.9) provides that there is to be added to the affiliate's "earnings" (as defined in subsection 5907(1) of the Regulations), for the last taxation year of the affiliate before the fresh start year, the total of the following amounts:

- the amount by which the actual reserves claimed exceed the maximum reserve allowed under paragraph 95(2)(*k*) of the Act for that last taxation year;

- where, because of paragraphs 95(2)(*k*) and 138(11.91)(*e*) of the Act, there is a deemed disposition of depreciable property that was used or held by the affiliate in the course of carrying on the foreign business, the amount by which the lesser of the fair market value and the cost to the affiliate of the property exceeds the undepreciated capital cost (or an analogous concept under the relevant foreign tax law) of the property at the end of that last taxation year; and

- where, because of paragraphs 95(2)(*k*) and 138(11.91)(*e*) of the Act, there is a deemed disposition of property (other than capital property) that was used or held by the affiliate in the course of carrying on the foreign business, the amount by which the fair market value of the property exceeds the cost of the property to the affiliate at the end of that last taxation year.

These additions to "earnings" result in corresponding increases in the balance of the affiliate's relevant surplus account.

In general terms, subsection 5907(2.9) provides that there is to be deducted from "earnings" for the last taxation year of the affiliate before the fresh start year the total of the following amounts:

- the maximum reserve allowed under paragraph 95(2)(*k*) of the Act minus the actual reserve claimed at the end of that last taxation year;

- where, because of paragraphs 95(2)(*k*) and 138(11.91)(*e*) of the Act, there is a deemed disposition of depreciable property that was used or held by the affiliate in the course of carrying on the foreign business, the amount by which the undepreciated capital cost of the property exceeds the lesser of fair market value and cost to the affiliate of the property at the end of that last taxation year; and

- where, because of paragraphs 95(2)(*k*) and 138(11.91)(*e*) of the Act, there is a deemed disposition of property (other than capital property) that was used or held by the affiliate in the course of carrying on the foreign business, the amount by which the cost of the property to the affiliate exceeds the fair market value of the property at the end of that last taxation year.

These decreases to "earnings" result in corresponding decreases in the balance of the affiliate's relevant surplus account.

Subsection 5907(2.9) of the Regulations is proposed to be amended to reflect the amendments to the Act which are set out in amended paragraph 95(2)(*k*), new paragraph 95(2)(*k*.1) and amended subsection 138(11.91) of the Act. In particular, subsection 5907(2.9) is proposed to be amended in the following ways.

First, subsection 5907(2.9) of the Regulations is proposed to be amended to reflect the proposed splitting of paragraph 95(2)(*k*) of the Act into paragraphs 95(2)(*k*) and (*k*.1).

Second, consistent with paragraphs 95(2)(*k*) and (*k*.1) of the Act, the proposed amendments to subsection 5907(2.9) of the Regulations ensure that the fresh start rules will apply where the foreign business is carried on by a partnership of which a foreign affiliate of a taxpayer is a member. These amendments to subsection 5907(2.9) ensure, in the case of partnerships, that the fresh start rules will work on the basis of fiscal periods of the partnership and that these rules will therefore be relevant in the computation of the affiliate's foreign accrual property income for the affiliate's taxation year that includes the end of a fiscal period to which the fresh start rules apply. The expression "operator" refers to the affiliate (in the case where the affiliate directly carries on the foreign business) or to the partnership (in the case where the partnership carries on the foreign business). The amounts added by subsection 5907(2.9) to "earnings" or "loss" are used in computing the earnings or loss from the foreign business (when it was an active business) of the affiliate in the preceding taxation year or fiscal period referred to in paragraph 95(2)(*k*), as the case may be, (which preceding taxation year or preceding fiscal period is referred to as the "preceding taxation year") in which the affiliate is deemed to have disposed of property.

Third, the proposed amendments to subsection 5907(2.9) modify the manner in which any necessary decreases are made to the affiliate's relevant surplus account. As noted above, existing subsection 5907(2.9) provides for the decreases to surplus to be made by way of decreases to "earnings". Amended subsection 5907(2.9) provides, instead, for those amounts to be placed in the "loss" (as defined in

subsection 5907(1)) of the affiliate, which result in corresponding decreases in the balance of the surplus account.

Fourth, amended subsection 5907(2.9) contains new rules in respect of eligible capital property and resource property to deal more appropriately with these types of property. As mentioned above, existing subsection 5907(2.9) ensures that where, because of paragraphs 95(2)(*k*) and 138(11.91)(*e*) of the Act, there is a deemed disposition of property that was used or held by the affiliate in the course of carrying on the foreign business, the affiliate's "earnings" are increased by the total of all amounts each of which is the amount by which the fair market value of the property (other than capital property) to the affiliate exceeds the cost of the property. (There is a corresponding rule in existing subsection 5907(2.9) that provides for a decrease of "earnings" if the cost of the property to the affiliate exceeds the fair market value of the property.)

As proposed to be amended, subsection 5907(2.9) ensures that where, because of paragraphs 95(2)(*k*) and 138(11.91)(*e*) of the Act, there is a deemed disposition of eligible capital property, the affiliate's "earnings" are increased by the amount, if any, required by subsection 14(1) of the Act to be included in computing the operator's income for that preceding taxation year from the foreign business. Conversely, amended subsection 5907(2.9) also ensures that, if the operator was, because of paragraphs 95(2)(*k*.1) and 138(11.91)(*e*) of the Act, deemed to have, at the end of that preceding taxation year, disposed of eligible capital property, the affiliate's "loss" is increased by the amount, if any, that would be permitted by paragraph 24(1)(*a*) of the Act to be deducted in computing the operator's income for that year from the foreign business if the operator had, immediately before the end of that year, ceased to carry on the foreign business.

For more detail about the treatment of the untaxed portion of the gain or loss from the sale of excluded property that is eligible capital property, refer to the commentaries on new paragraph (*a*.1) of the definition "exempt earnings", and new paragraph (*a*.1) of the definition "exempt loss", respectively, in subsection 5907(1) of the Regulations.

Amended subsection 5907(2.9) ensures that where, because of paragraphs 95(2)(*k*) and 138(11.91)(*e*) of the Act, there is a deemed disposition of resource property, the affiliate's "earnings" are increased by the amount, if any, by which

- the total of all amounts included by subsection 59(1) or paragraph 59(3.2)(*c*) or (*c*.1) of the Act in computing the operator's income for that preceding taxation year from the active business

exceeds

- the total of all amounts that were deductible under section 66, 66.1, 66.2, 66.21 or 66.4 of the Act in computing the operator's income for that year from the active business.

Note that there is a corresponding rule in amended subsection 5907(2.9) for an inclusion in "loss" in the converse situation.

Fifth, proposed amendments to subsection 5907(2.9) provide a rule for the determination, where the operator is the partnership, of the amounts required by that subsection to be added to the affiliate's "earnings" or "loss", as the case may be, for the preceding taxation year. The amount of the increase to the affiliate's "earnings" or "loss" is essentially the amount of the increase to the "earnings" or "loss" for the partnership multiplied by the fraction the numerator of which is the affiliate's share of the income or loss of the partnership for that year and the denominator of which is the income or loss of the partnership for that year. For the purpose of this calculation, where both the income and the loss of the partnership for that preceding year are nil, the partnership is assumed to have an income of $1 million for that year.

The amendments to subsection 5907(2.9) of the Regulations are proposed to apply to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002. Note that these amendments are included in the Fresh Start Section 95 Election package described at the beginning of the commentary to section 95 of the Act.

ITR
5907(2.91)

Proposed new subsection 5907(2.91) of the Regulations is consequential to the introduction of new paragraphs 95(2)(*k*.1) and (*k*.3) of the Act. New subsection 5907(2.91) provides that, for the purposes of section 5907 of the Regulations, any property of a foreign affiliate of a corporation resident in Canada, or of a partnership of which a foreign affiliate of a corporation resident in Canada is a member, that is, for the purposes of subdivision i of Division B of Part I of the Act, deemed because of either paragraph 95(2)(*k*.1) or (*k*.3), and paragraph 138(11.91)(*e*), of the Act to have been disposed of and reacquired by the affiliate or the partnership, as the case may be, is, for the purpose of section 5907 of the Regulations, deemed to have been disposed of and reacquired by the affiliate or the partnership, as the case may be, in the same manner and for the same amounts as if those provisions applied for the purpose of section 5907 of the Regulations.

Subsection 5907(2.91) ensures that the deemed disposition and reacquisition are taken into account when calculating a foreign affiliate's surplus accounts.

New subsection 5907(2.91) of the Regulations is proposed to apply to taxation years, of a foreign affiliate of a taxpayer, that begin after December 20, 2002. Note that this amendment is included in the Fresh Start Section 95 Election package described at the beginning of the commentary to section 95 of the Act.

ITR
5907(5.1)

Subsection 5907(5.1) of the Regulations is repealed because of the introduction of the rules in paragraphs 95(2)(*c*.2) to (*c*.6) and paragraphs 95(2)(*f*.3) to (*f*.8) of the Act. See the commentary for those proposed new paragraphs.

ITR
5907(9) and (9.1)

Where a foreign affiliate of a taxpayer resident in Canada has been dissolved, subject to the rules in paragraph 95(2)(*e*.1) of the Act, subsection 5907(9) of the Regulations provides that certain rules apply for the purposes of computing the various amounts referred to in section 5907 of the Regulations.

It is proposed that subsection 5907(9) of the Regulations be amended so that the rules will be subject to the rules in proposed new paragraphs 95(2)(*e*) and (*e*.1) and subsection 88(3). See the commentary for the proposed new paragraphs and subsection.

It is also proposed that subsection 5907(9) of the Regulations be amended so that the rules do not apply to dissolutions of a foreign affiliate because of a foreign merger within the meaning assigned by subsection 87(8.1) of the Act.

Proposed new subsection 5907(9.1) of the Regulations provides rules similar to those contained in proposed amended subsection 5907(9) of the Regulations that apply on transfers of property by a foreign affiliate of a taxpayer resident in Canada as a payment of a dividend or as a distribution of property to a shareholder of the foreign affiliate.

This amendment is proposed to apply to dissolutions, payments of dividends and distributions made after the after December 20, 2002.

ITR
5907(13) and (14)

Subsection 5907(13) of the Regulations adds a prescribed amount to the foreign accrual property income (FAPI) of a foreign affiliate that immigrates to Canada. The starting-point for the determination of this amount is paragraph 5907(13)(*a*), which refers to the affiliate's taxable surplus for the taxation year that is deemed under section 128.1 of the Act to have ended before immigration (excluding net earnings in respect of FAPI).

Under section 128.1 of the Act, one of the tax consequences of immigration to Canada is a deemed disposition of most kinds of property. That deemed disposition will often cause an increase in the taxable surplus of an immigrating foreign affiliate. To ensure the appropriate measurement of such an increase, paragraph 5907(13)(*a*) of the Regulations is amended to exclude, from the taxable surplus amount it describes, any amount that would have been added to the affiliate's underlying foreign tax if the deemed disposition had been an actual disposition. This amendment generally applies after 1992. The sole exception is that if the affiliate continued into Canada before 1993 and elected, under paragraph 111(4)(*a*) of S.C. 1994, c. 21, to have subsection 250(5.1) of the Act apply in respect of the continuation, this amendment will apply to the affiliate from the time of that continuation.

In some instances, the gains that an immigrating affiliate would realize if it had actually disposed of its property would not in fact be subject to any foreign tax. New subsection 5907(14) of the Regulations ensures that in such a case, subsection 5907(13) does not recognize any addition to the affiliate's underlying foreign tax. This new subsection applies after 1992, except that its application is confined to paragraph 5907(13)(*a*) in respect of dispositions that occur on or before Announcement Date.

ITR
5911(1) and (2)

Proposed new subsections 5911(1) and (2) of the Regulations set out the rules for determining the additions to and the deductions from the adjusted cost base of a share of a foreign affiliate of a corporation resident in Canada required under paragraphs 92(1.3)(*a*) and (*b*) of the Act when there has been a specified section 93 election in respect of a relevant share. Refer to the commentary for proposed new subsections 92(1.1) to (1.4) of the Act for the definitions "election time", "relevant share", "relevant foreign affiliate" and "specified section 93 election", the adjusted cost

base adjustment requirements and the purposes for which the adjustments to the cost base of shares are to be made.

Proposed new subsections 5911(1) and (2) of the Regulations apply after December 20, 2002.

New subsection 5911(1) of the Regulations determines the required addition to the adjusted cost base of a relevant share in respect of a specified section 93 election.

The amount prescribed, for the purpose of paragraph 92(1.3)(*a*) of the Act, in respect of the relevant share referred to in that paragraph, in respect of a specified section 93 election related to the relevant share, is the lesser of

- the amount, if any, by which the fair market value exceeds the adjusted cost base to the holder, at the election time, of the relevant share, and

- the amount determined by the formula

$$A/C \times (C - B)$$

where

A is the amount that would be determined to be the attributed net surplus in respect of the relevant share, in respect of the specified section 93 election, under proposed new paragraph 5902(1)(*f*) of the Regulations if the relevant share were the disposed share referred to in subsection 5902(1) and the relevant affiliate were the disposed affiliate referred to in subsection 5902(1),

B is the amount that would be determined to be the consolidated net surplus in respect of the relevant affiliate under proposed new subparagraph 5902(1)(*e*)(vi) if the relevant foreign affiliate was the disposed affiliate referred to in subsection 5902(1), the relevant share was the disposed share referred to in subsection 5902(1) that was disposed of immediately after the disposition of the disposed share to which the specified section 93 election applied and, before that determination, the surplus accounts of the relevant foreign affiliate and each foreign affiliate in which the relevant foreign affiliate had an equity percentage were adjusted in accordance with section 5905, and

C is the amount that would be determined to be the consolidated net surplus in respect of the relevant affiliate, in respect of the specified section 93 election, under proposed new subparagraph

5902(1)(*e*)(vi) if the relevant foreign affiliate was the disposed affiliate referred to in subsection 5902(1) and the relevant share was the disposed share referred to in subsection 5902(1).

Proposed subsection 5911(2) of the Regulations determines the required deduction to the adjusted cost base of a relevant share in respect of a specified section 93 election.

The amount prescribed, for the purpose of paragraph 92(1.3)(*b*) of the Act, in respect of the relevant share referred to in that paragraph, in respect of a specified section 93 election related to the relevant share, is the lesser of

- the amount, if any, by which the adjusted cost base to the holder exceeds the fair market value, at the election time, of the relevant share, and

- the amount determined by the formula

$$A/C \times (C - B)$$

where

A is the amount that would be determined to be the attributed net surplus in respect of the relevant share, in respect of the specified section 93 election, under proposed new paragraph 5902(1)(*f*) of the Regulations if the relevant share was the disposed share referred to in subsection 5902(1), the relevant affiliate was the disposed affiliate referred to in subsection 5902(1) and the consolidated net surplus was the amount determined for C,

B is the amount, if any, by which the amount that would be determined under clause 5902(1)(*e*)(vi)(B) in respect of the relevant affiliate exceeds the amount that would be determined under clause 5902(1)(*e*)(vi)(A) in respect of the relevant affiliate if the relevant foreign affiliate was the disposed affiliate referred to in subsection 5902(1), the relevant share was the disposed share referred to in subsection 5902(1) that was disposed of immediately after the disposition of the disposed share to which the specified section 93 election applied and, before the determination, the surplus accounts of the relevant foreign affiliate and each foreign affiliate in which the relevant foreign affiliate had an equity percentage were adjusted in accordance with section 5905, and

C is the amount, if any, by which the amount that would be determined under clause 5902(1)(*e*)(vi)(B) in respect of the

relevant affiliate in respect of the specified section 93 election exceeds the total that would be determined under clause 5902(1)(*e*)(vi)(A) in respect of the relevant affiliate in respect of the specified section 93 election if the relevant share was the disposed share referred to in subsection 5902(1) and the relevant affiliate was the disposed affiliate referred to in subsection 5902(1).

Proposed new subsection 5911(3) of the Regulations determines the required addition to the adjusted cost base of a relevant share in respect of a specified section 93 election amount determined in the formulas in subsections 5911(1) and (2) in respect of the relevant share referred to in paragraph 92(1.3)(*a*) is nil.

If the amount determined in each of the formulas in paragraphs 5911(1)(*b*) and 5911(2)(*b*) in respect of the relevant share referred to in paragraph 92(1.3)(*a*) of the Act is nil, the amount determined for B in the formula in paragraph 5911(1)(*b*) in respect of the relevant affiliate is greater than nil and the amount determined for C in the formula in paragraph 5911(2)(*b*) in respect of the relevant affiliate is greater than nil, the amount prescribed for the purpose of paragraph 92(1.3)(*a*) of the Act, in respect of the relevant share referred to in that paragraph, in respect of a specified section 93 election related to the relevant share, is the lesser of

- the amount, if any, by which the fair market value of the relevant share, at the election time, exceeds the adjusted cost base, at the time of the disposition, of the relevant share to the holder, and

- the amount that would, if the relevant share was the disposed share and the relevant affiliate was the disposed affiliate in respect of the specified section 93 election, be determined under paragraph 5902(1)(*f*) to be the attributed net surplus in respect of the relevant share if the consolidated net surplus of the relevant foreign affiliate were the amount determined for B in the formula in paragraph 5911(1)(*b*).

***Example***

***Facts***

*1. Canco, a corporation resident in Canada, owns 100% of the issued shares of FA1 (which owns 80% of the issued shares of FA2) and 50% of the issued shares of FA6 (which owns 20% of the issued shares of FA2).*

*2. FA2 owns 70% of the issued shares of FA3, which owns 100% of the issued shares of FA4 (which owns 100% of the issued shares of FA5).*

*3. FA1 sells 30 issued shares of FA2 to FA6 and Canco elects under subsection 93(1) of the Act ($123 of sale proceeds to be treated as dividends on the 30 disposed shares of FA2).*

*4. At the time of the sale, FA2 has an exempt surplus of $200, a taxable surplus of $0, an exempt deficit of $0 and an underlying foreign tax of $0.*

*5. At the time of the sale, FA3 has an exempt surplus of $100, a taxable surplus of $75, an exempt deficit of $0 and an underlying foreign tax of $10.*

*6. At the time of the sale, FA4 has an exempt surplus of $0, a taxable surplus of $0, an exempt deficit of $200 and an underlying foreign tax of $0.*

*7. At the time of the sale, FA5 has an exempt surplus of $0, a taxable surplus of $325, an exempt deficit of $0 and an underlying foreign tax of $200.*

*8. All the corporations have 100 issued shares of one class of shares.*

***Application of Sections 5902, 5905 and 5911***

*For the application of subsection 5902(1) - see the example in the commentary for that subsection.*

*For the application of subsection 5905(8) - see the example in the commentary for that subsection.*

*For the application of subsections 5911(1) and (3) - see the calculation below.*

***Application of Section 5911 of the Regulations***

*Subsection 5911 of the Regulations provides for adjustments to the cost base to the holder of the share of the relevant foreign affiliate in respect of the adjustments to the surplus balances under section 5905 of the Regulations in respect of a specified section 93 election related to the relevant share.*

*The calculation is being performed only for the shares of FA4 and FA5 in this example.*

### *Subsection 5911(1) - Additions to the ACB of Shares*

*For the purposes of the calculations below, it is assumed that the fair market value exceeded the adjusted cost base to the holder of shares of the relevant foreign affiliates.*

#### *Calculation - FA5*

*Under subsection 5911(1), the required addition to the adjusted cost base of a share of FA5, for example, is $0.65 determined by the formula*

$$A \times (C\text{-}B)/C) = (3.25 \times (325\text{-}260)/325) = \$0.65$$

*where*

*A is the amount that would be determined to be the attributed surplus in respect of a share of FA5 if the share of FA5 and FA5 were the "disposed share" and the "disposed foreign affiliate" referred to in subsection 5902(1) in respect of the specified section 93 election ($325/100 = $3.25),*

*B is the amount that would be determined to be the consolidated net surplus (after the application, in respect of the specified section 93 election, of subsection 5905(8) to FA5) under 5902(1) in respect of FA5 if the share of FA5 and FA5 were the disposed share and the disposed foreign affiliate referred to in subsection 5902(1) in respect of a disposition, immediately after the disposition to which the specified section 93 election applies, of the FA5 share in respect of which an election was made by Canco under subsection 93(1) ($260), and*

*C is the amount that would be determined to be consolidated net surplus of FA5, in respect of the specified section 93 election, under 5902(1) in respect of FA5 if the share of FA5 and FA5 were the disposed share and the disposed foreign affiliate referred to in subsection 5902(1) ($325).*

#### *Calculation - FA4*

*Under subsection 5911(3), the required addition to the adjusted cost base of a share of FA4, for example, is $2.60. This amount is determined as the amount that would, if the share of FA4 was the disposed share and FA4 was the disposed affiliate, be determined under paragraph 5902(1)(f) to be the attributed net surplus in respect of the FA4 share ($260/100 shares) if the consolidated net surplus of the FA4 were the amount determined in respect of FA4 for B in the formula in subsection 5911(1) ($260).*

*The amount determined for B in the formula in subsection 5911(1) is the amount that would be determined to be the consolidated net surplus (after the application, in respect of the specified section 93 election, of subsection 5905(8) to FA4) under subsection 5902(1) in respect of FA4 if the share of FA4 and FA4 were the disposed share and the disposed foreign affiliate referred to in subsection 5902(1) in respect of a disposition, immediately after the disposition to which the specified section 93 election applies, of the FA4 share in respect of which an election was made by Canco under subsection 93(1) ($260).*

ITR
5912

Proposed new subsection 5912 of the Regulations determines the amount to be included as the adjusted suspended gain and the adjusted allocable tax in respect of the specified share, of the relevant foreign affiliate (referred to in new paragraph 95(2)(*c*.3) of the Act), at the earlier of the first times (which earlier time is referred to as the "recognition time"), after the original disposition time, that is described by new paragraph 95(2)(*c*.3) of the Act.

Proposed new subsection 5912 of the Regulations applies after December 20, 2002.

New subsection 5912(1) provides the rules for the calculation of the adjusted suspended gain in respect of the specified share, of the relevant foreign affiliate (referred to in new paragraph 95(2)(*c*.3) of the Act), at the recognition time. This amount is determined by the formula

$$A \times B/C$$

where

A is the amount of the unadjusted suspended gain in respect of a specified share of the relevant foreign affiliate at the original disposition time,

B is the surplus entitlement percentage of the corporation resident in Canada in respect of the relevant foreign affiliate immediately before the original disposition time determined assuming that the taxation year of the relevant foreign affiliate that otherwise would have included that time had ended immediately before that time, and

C is the surplus entitlement percentage of the corporation resident in Canada in respect of the relevant foreign affiliate immediately before the recognition time determined assuming

that the taxation year of the relevant foreign affiliate that otherwise would have included that time had ended immediately before that time.

New subsection 5912(2) provides for the calculation of the adjusted allocable tax in respect of the adjusted suspended gain, in respect of the specified share, of the relevant foreign affiliate (referred to in new paragraph 95(2)(*c*.3)) at the recognition time. This amount is determined by the formula

$$A \times B/C$$

where

A is any income or profits tax paid to the government of a country by the relevant foreign affiliate that can reasonably be regarded as tax in respect of the unadjusted suspended gain in respect of the specified share,

B is the surplus entitlement percentage of the corporation resident in Canada in respect of the relevant foreign affiliate immediately before the original disposition time determined on the assumption that the taxation year of the relevant foreign affiliate that otherwise would have included that time had ended immediately before that time, and

C is the surplus entitlement percentage of the corporation resident in Canada in respect of the relevant foreign affiliate immediately before the recognition time determined on the assumption that the taxation year of the relevant foreign affiliate that otherwise would have included that time had ended immediately before that time.

ITR
5913

New section 5913 of the Regulations determines the amount to be included as the adjusted suspended income or gain in respect of the specified property, of the relevant foreign affiliate (referred to in new paragraph 95(2)(*f*.5) of the Act), at the earlier of the first times (which earlier time is referred to as the "recognition time"), after the original disposition time (referred to in new paragraph 95(2)(*f*.5) of the Act), that is described by new paragraph 95(2)(*f*.5) of the Act.

Proposed new subsection 5913 of the Regulations applies after December 20, 2002.

New subsection 5913(1) provides rules for the calculation of the adjusted suspended income or gain in respect of the specified property, of the relevant foreign affiliate (referred to in new paragraph 95(2)(*f*.5)), at the recognition time. This amount is determined by the formula

A x B/C

where

A is the amount of the unadjusted suspended income or gain in respect of a specified property of the relevant foreign affiliate at the original disposition time,

B is the surplus entitlement percentage of the corporation resident in Canada in respect of the relevant foreign affiliate immediately before the original disposition time determined assuming that the taxation year of the relevant foreign affiliate that otherwise would have included that time had ended immediately before that time, and

C is the surplus entitlement percentage of the corporation resident in Canada in respect of the relevant foreign affiliate immediately before the recognition time determined assuming that the taxation year of the relevant foreign affiliate that otherwise would have included that time had ended immediately before that time.

New subsection 5913(2) provides for the calculation of the adjusted allocable tax in respect of the adjusted suspended income or gain, in respect of the specified property, of the relevant foreign affiliate (referred to in new paragraph 95(2)(*f*.5)) at the recognition time. This amount is determined by the formula

A x B/C

where

A is any income or profits tax paid to the government of a country by the relevant foreign affiliate that can reasonably be regarded as tax in respect of the unadjusted suspended income or gain in respect of the specified property,

B is the surplus entitlement percentage of the corporation resident in Canada in respect of the relevant foreign affiliate immediately before the original disposition time determined on the assumption that the taxation year of the relevant foreign

affiliate that otherwise would have included that time had ended immediately before that time, and

C is the surplus entitlement percentage of the corporation resident in Canada in respect of the relevant foreign affiliate immediately before the recognition time determined on the assumption that the taxation year of the relevant foreign affiliate that otherwise would have included that time had ended immediately before that time.

ITR
5914

New section 5914 of the Regulations determines the amount to be included as the adjusted suspended loss or capital loss in respect of the specified property, of the relevant foreign affiliate (referred to in new paragraph 95(2)(*h*.3) of the Act), at the earlier of the first times (which earlier time is referred to as the "recognition time"), after the original disposition time (referred to in new paragraph 95(2)(*h*.3) of the Act), that is described by new paragraph 95(2)(*h*.3) of the Act.

Proposed new subsection 5914 of the Regulations applies after December 20, 2002.

New subsection 5914(1) provides for the calculation of the adjusted suspended loss or capital loss in respect of the specified property, of the relevant foreign affiliate (referred to in new paragraph 95(2)(*h*.2)), at the recognition time. This amount is determined by the formula

$$A \times B/C$$

where

A is the amount of the unadjusted suspended loss or capital loss in respect of a specified property of the relevant foreign affiliate at the original disposition time,

B is the surplus entitlement percentage of the corporation resident in Canada in respect of the relevant foreign affiliate immediately before the original disposition time determined assuming that the taxation year of the relevant foreign affiliate that otherwise would have included that time had ended immediately before that time, and

C is the surplus entitlement percentage of the corporation resident in Canada in respect of the relevant foreign affiliate immediately before the recognition time determined on the assumption that the taxation year of the relevant foreign affiliate

that otherwise would have included that time had ended immediately before that time.

New subsection 5914(2) provides for the calculation of the adjusted allocable tax refund in respect of the adjusted suspended loss or capital loss, in respect of the specified property, of the relevant foreign affiliate (referred to in new paragraph 95(2)(*h*.2)) at the recognition time. This amount is determined by the formula

$$A \times B/C$$

where

A is any income or profits tax refunded by the government of a country to the relevant foreign affiliate that can reasonably be regarded as tax refunded in respect of the unadjusted suspended loss or capital loss in respect of the specified property,

B is the surplus entitlement percentage of the corporation resident in Canada in respect of the relevant foreign affiliate immediately before the original disposition time determined on the assumption that the taxation year of the relevant foreign affiliate that otherwise would have included that time had ended immediately before that time, and

C is the surplus entitlement percentage of the corporation resident in Canada in respect of the relevant foreign affiliate immediately before the recognition time determined on the assumption that the taxation year of the relevant foreign affiliate that otherwise would have included that time had ended immediately before that time.

ITR
5915

Proposed section 5915 of the Regulations sets out the requirements for an election by a corporation resident in Canada under proposed paragraph 95(2)(*c*.2) of the Act.

Proposed new subsection 5915 of the Regulations applies after December 20, 2002.

Generally, the new section requires the election to be made by filing the prescribed form with the Minister of National Revenue on or before

- if a foreign affiliate of the corporation resident in Canada was the vendor that disposed of the specified share, the filing-due date of

the corporation resident in Canada for its taxation year that includes the last day of the foreign affiliate's taxation year in which the disposition was made; and

- if a foreign affiliate of the corporation resident in Canada is a member of a partnership that was the vendor that disposed of the specified share, the filing-due date of the corporation resident in Canada for its taxation year that includes the last day of the taxation year of the foreign affiliate that includes the last day of the partnership's fiscal period in which the disposition was made by the partnership.

ITR
5916

Proposed section 5916 of the Regulations sets out the requirements for an election by a corporation resident in Canada under subsection 88(3) or clause 95(2)(*d*)(iii)(A), (*e*)(v)(B), (*e*.3)(iv)(B), (*e*.4)(v)(B) or (*e*.5)(v)(B) of the Act.

Proposed new subsection 5916 of the Regulations applies after December 20, 2002.

Generally, the section requires the election to be made by filing the prescribed form with the Minister of National Revenue on or before

- if a foreign affiliate of the corporation resident in Canada made the disposition, the filing-due date of the corporation resident in Canada for its taxation year that includes the last day of the foreign affiliate's taxation year in which the disposition was made; and
- if a foreign affiliate of the corporation resident in Canada is a member of a partnership and that partnership made the disposition, the filing-due date of the corporation resident in Canada for its taxation year that includes the last day of the taxation year of the foreign affiliate that includes the last day of the partnership's fiscal period in which the disposition was made by the partnership.

ITR
5917

Proposed section 5917 of the Regulations sets out the requirements for an election by a corporation resident in Canada under paragraph 95(2)(*f*.4) of the Act.

Proposed subsection 5917 of the Regulations applies after December 20, 2002.

Generally, the section requires the election to be made by filing the prescribed form with the Minister of National Revenue on or before

- if a foreign affiliate of the corporation resident in Canada was the vendor that disposed of the specified property, the filing-due date of the corporation resident in Canada for its taxation year that includes the last day of the foreign affiliate's taxation year in which the disposition was made; and

- if a foreign affiliate of the corporation resident in Canada is a member of a partnership that was the vendor that disposed of the specified property, the filing-due date of the corporation resident in Canada for its taxation year that includes the last day of the taxation year of the foreign affiliate that includes the last day of the partnership's fiscal period in which the disposition was made by the partnership.

ITR
5918

Proposed section 5918 of the Regulations sets out the requirements for an election by a corporation resident in Canada under new subparagraph 95(2)(*k*.3)(iii) of the Act. For further detail, see the commentary to paragraph 95(2)(*k*.3) of the Act.

Proposed new subsection 5918 of the Regulations applies after December 20, 2002.

Generally, the section requires the election to be made by filing the prescribed form with the Minister of National Revenue on or before

- if a foreign affiliate of the taxpayer was the operator, the taxpayer's filing-due date for its taxation year that includes the last day of the foreign affiliate's taxation year that is the specified taxation year; and

- if a partnership - of which a foreign affiliate of the taxpayer was, or was deemed by new paragraph 95(2)(*k*.7) of the Act to be, a member - was the operator, the taxpayer's filing-due date for its taxation year that includes the last day of the taxation year of the foreign affiliate that includes the last day of the partnership's fiscal period that is the specified taxation year.

ITR
5919

New section 5919 of the Regulations sets out the requirements for an election, under paragraph 88(3)(*a*) of the Act, by a corporation resident in Canada in respect of the disposition of shares in the capital of one of the foreign affiliates of the corporation resident in Canada by another of the foreign affiliates of the corporation resident in Canada. The proposed section states that an election under paragraph 88(3)(*a*) of the Act shall be made by filing the prescribed form with the Minister of National Revenue, on or before the filing-due date of the taxation year of the corporation resident in Canada that includes the last day of the other foreign affiliate's taxation year in which the other foreign affiliate made the disposition.

Proposed new subsection 5919 of the Regulations applies after December 20, 2002.

# APPENDIX D

## PRESCRIBED PROPERTIES AND PERMANENT ESTABLISHMENTS

Part LXXXII of the *Income Tax Regulations* prescribes property, and defines the expression "permanent establishment", for various purposes of the *Income Tax Act*.

The Regulations are being amended to add new section 8202.

New subsection 8202(1) of the Regulations defines the term "permanent establishment" of a person or partnership for the purposes of the definition "investment business" in subsection 95(1) of the Act, paragraph 95(2)(*l*)(iii) of the Act, and paragraphs 95(2.3)(*b*) and (2.4)(*a*) of the Act to mean

- a fixed place of business of a person or partnership, including an office, a branch, a mine, an oil well, a farm, a timberland, a factory, a workshop or a warehouse, or

- where the person or partnership does not have any fixed place of business, the principal place at which the business of the person or partnership is conducted.

New subsection 8202(2) of the Regulations provides that the definition of permanent establishment in a tax treaty that Canada has with a foreign country takes precedence over subsection 8202(1) if the person or partnership is resident in that foreign country.

New subsection 8202(3) of the Regulations provides other rules for the purposes of determining if a fixed place of business exists for the purposes of subsection 8202(1).

New section 8202 applies to the 1999 and subsequent taxation years. However, where the taxpayer has made a valid Global Section 95 Election, new subsection 8202 applies to 1994 and subsequent taxation years.  For information about the Global Section 95 Election, see the beginning of the commentary to section 95 of the Act.